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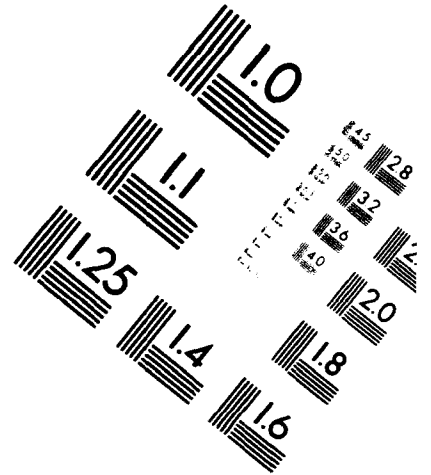
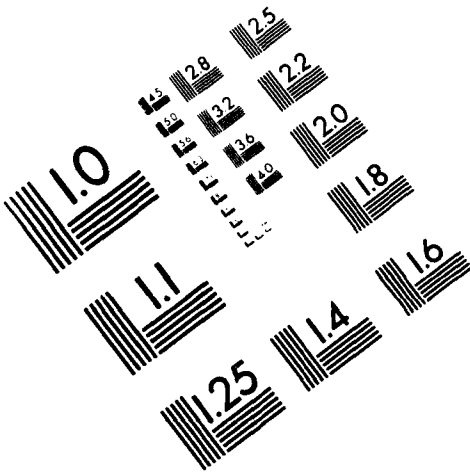


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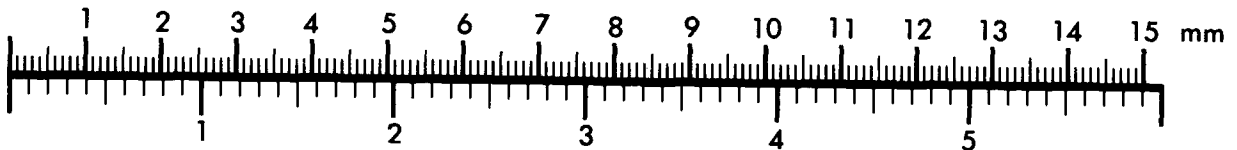
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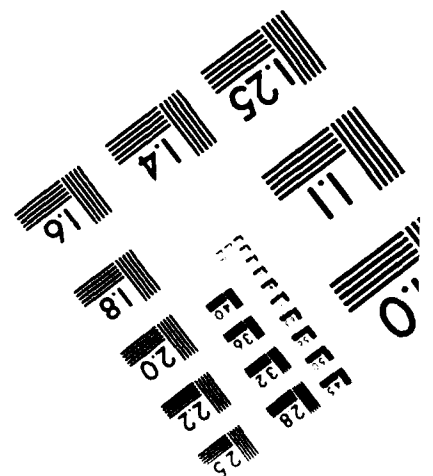
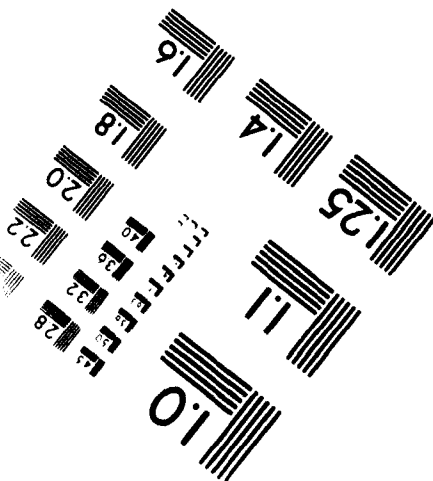
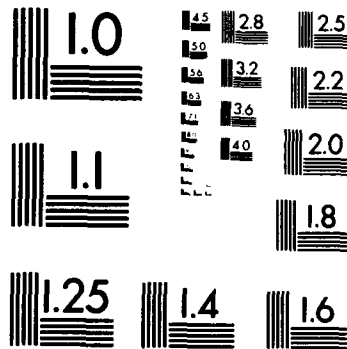
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**Vol. 1 of 2
Chapters 1-11**

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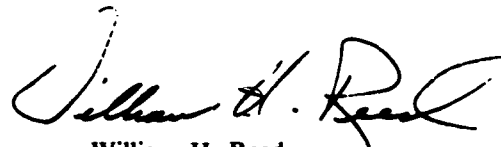
DCAA CONTRACT AUDIT MANUAL

FOREWORD

The DCAA Contract Audit Manual (DCAA Manual 7640.1) is an official publication of the Defense Contract Audit Agency (DCAA). It prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission.

All DCAA supervisory personnel should promote the study and use of the manual by their audit staffs. Further, all DCAA personnel are encouraged to submit recommendations for constructive changes or improvement to the manual.

The manual is designed to minimize the necessity of referring to other publications for technical and procedural guidance; therefore, technical supplemental guidance or instructions will not be issued by regional offices except as specifically authorized by the Director, DCAA.

A handwritten signature in black ink, appearing to read "William H. Reed", is positioned above the printed name and title.

William H. Reed
Director

January 1995

(5)

DCAA CONTRACT AUDIT MANUAL

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**JANUARY 1995 EDITION OF THE DCAA CONTRACT
AUDIT MANUAL — DCAAM 7640.1
NOTES ON SUBSTANTIVE CHANGES**

For your convenience, the following is a list of all substantive changes to this edition of the DCAA Contract Audit Manual (CAM). Each one is summarized in the notes below and also highlighted in the text with a vertical bar in the margin.

Internal Controls

This CAM Edition reflects extensive revisions to improve DCAA's policy and procedures for understanding, evaluating, and reporting on contractor's internal control systems. This CAM also provides enhanced guidance on translating the review of the contractor's internal controls into the risk assessment and the substantive testing plan. The following are the key changes:

- 3-100 Includes additional audit planning considerations relating to the review of internal controls.
- 3-300 Provides guidance on using the new Internal Control Audit Planning Summary sheets to summarize the review of internal controls and the impact of the review on the scope of other related audits.
- 5-100 Includes the overall guidance on understanding, evaluating, and reporting on internal controls at major contractors and nonmajor contractors with internal control systems. Also includes guidance on considering the results of reviewing the contractor's internal controls when determining the scope of other related audits.
- 5-110 and 10-400 Includes guidance on reporting on the contractor's internal control systems.
- 5-111 Includes guidance on reviewing internal controls at nonmajor contractors.
- 5-300 to 5-1200 Provides specific guidance on understanding and evaluating internal controls for each of the ten major systems usually found in the contract audit environment at major contractors. New standard audit programs for each of the ten systems are on the DIIS. Previous sections of Chapter 5 were moved to the following locations:
 - 14-200 - Review of Progress Payments
 - 14-500 - Operations Audits and Other Functional Reviews
 - 14-600 - Review of Contractor Capital Investment Projects
 - 14-700 - Review of Production Scheduling and Control

- 14-800 - Advance Cost Management Systems
- 15-700 - Review of Production Scheduling and Control

5-1200 The previous CAM coverage on estimating system reviews in 9-1100 was moved to 5-1200.

Chapter 6 Includes several enhancements for considering the results of reviewing the contractor's internal control systems when developing the substantive testing plans. As a result of these internal control changes, the following MRD is superseded:

94-PFD-088, 24 May 1994

The following are summaries of the other substantive changes included in this CAM Edition, by CAM Chapter:

Chapter 1

1-409 Revises guidance on responding to requests by Members of Congress and Congressional committees. (Also view the video (SIFA-13), entitled DCAA Auditors and Oversight Groups, which is available in the FAO Training Library.)

Chapter 3

3-200 Clarifies and enhances guidance for briefing contracts and requests for proposals/quotes.

Chapter 4

4-600 Updates audit sampling guidance to reference the Electronic Selection Program (ESP) and eliminate reference to the COSAM software package.

4-702 Expands guidance to include relations with DOJ trial attorneys and civil investigations to be covered by Joint Policy Memorandum No. 2. Adds civil investigative demands as a class of documents to be safeguarded.

4-703 Includes revised guidance regarding the responsibilities of the Designated Agency Ethics Official.

4-707 Adds guidance relating to contractor voluntary disclosures.

4-710 Adds a new section relating to the Defense Hotline requirements and procedures.

4-711 Adds a new section on providing assistance to the suspension and/or debarment official in reviewing contractor compliance with suspension and debarment agreements.

Chapter 5

- 5-110 Includes guidance on assessing to the impact of internal control deficiencies on contractor's billings. Discusses the auditor's responsibilities for suspending costs or recommending cost suspensions to the contracting officer. Related audit guidance is also included in 10-408 and 14-206.

Chapter 6

- 6-305 Provides additional guidance on performing MAAR 13 - Purchases Existence and Consumption at small, low risk contractors. The following MRD is superseded:

92-PFD-188, 9 December 1992

- 6-414 Provides additional guidance on reviewing executive compensation.

- 6-608 Provides additional guidance on developing the substantive testing plan for the review of incurred costs. The following MRD is superseded:

92-PFD-140, 16 September 1992

- 6-608 Adds definition of expressly unallowable costs as used in the penalty regulation. Adds guidance on using statistical sampling techniques to estimate costs subject to penalty. Clarifies guidance on recommending penalties on unallowable corporate costs. The following MRDs are superseded:

94-PAD-069, 20 April 1994

94-PAD-060, 8 April 1994

93-PAD-235, 29 November 1993

92-PAD-179, 10 September 1993

92-PAD-195, 29 September 1993

- 6-706 Clarifies guidance on the MAARS that can be performed prior to the receipt of a certified incurred costs submission. The following MRD is superseded:

94-OPD-061, 2 May 1994

- 6-709 and 6-800 Revises guidance on requesting and reviewing assist audits on incurred subcontract costs as a result of regional and field audit office recommendations.

Chapter 7

- 7-403 Adds guidance for the auditor to verify the cost of assets.

- 7-1202 Clarifies guidance on the allowability of costs related to air shows, special events, and trade shows. The following MRD is superseded:

93-PAD-064, 1 April 1993

- 7-1500 Revises guidance to reflect the new IR&D and B&P allowability rules. The following MRDs are superseded:

92-PAD-202, 29 December 1992

94-PAD-007, 13 January 1994

- 7-1907 Adds new guidance on the WARN act as it relates to terminated contracts. The following MRD is superseded:

93-PAD-112, 7 June 1993

- 7-1914 Provides guidance relating to application of discounts for minority interest and lack of marketability for contractor stock valuations when reviewing employee stock ownership plans.

- 7-1920 Incorporates guidance on the allowability of environmental clean-up costs attributable to other potentially responsible parties' contamination. The following MRD is superseded:

94-PAD-030, 23 February 1994

Chapter 8

- 8-410 Updates guidance to discuss the results of a recent ASBCA case ruling that the G&A allocation base should include unallowable costs. The following MRD is superseded:

94-PAD-016, 1 February 1994

Chapter 9

- 9-108, 9-206, Clarifies reporting guidance for agreed-upon procedures
9-207, 9-209 and specified cost element reviews.

- 9-605 Updates guidance to show the extension of dates for the class deviation from the FAR requirement to use the Special Tooling clause. The following MRD is superseded:

93-PAD-219, 8 November 1993

- 9-1400 Updates guidance to reflect the revised FAR criteria relating to the use of flexible progress payment rates. Also includes guidance on using and reviewing data input/output for the new CASH VI model.

Chapter 10

During the finalization of this CAM update, the Agency adopted the new audit report format described in MRD 94-PFD- 163, dated 26 September 1994. FAOs began

using the new format 31 October 1994 and sample audit reports using the new guidance were added to the DCAA Bulletin Board under the file name NUFORMAT.ZIP.

At this printing, Chapter 10 is only partly revised to incorporate the new report format guidance (i.e., 10-400). During the transition, auditors should adapt the guidance in Chapter 10 to the reporting format in MRD 94-PFD-163 and the examples in NUFORMAT.ZIP.

10-304, 10-306 Clarifies reporting guidance for agreed-upon procedures and specified cost element reviews.

10-504 Adds guidance for reporting on subcontract costs when the assist audits have not yet been received.

Chapter 11

11-207 Adds guidance on evaluating contractor estimates at completion (EACs) during C/SCSC audits. The following MRD is superseded:

93-OAD-109, 3 June 1993

Chapter 13

13-207, 13-694 Provides guidance on reviewing predetermined fixed indirect expense rates at universities. The following MRDs are superseded:

94-PFD-189, 7 November 1994

93-PFD-141, 20 July 1993

13-307 Updates guidance on DCAA responsibilities on accomplishing the general and specific requirements contained in the OMB Circular A-133 Compliance Supplement. The following MRDs are superseded:

94-PFD-070, 22 April 1994

92-PFD-110, 27 July 1992

13-804 Provides guidance on accrual vs cash accounting at nonprofit institutions. The following MRD is superseded:

93-PFD-229, 17 November 1993

13-S1 Adds Change 5 to the OMB Circular A-21 cost principles. The following MRD is superseded:

93-PFD-165, 26 August 1993

Chapter 14

14-124 Clarifies guidance on the relevant date to begin computing interest on defectively priced subcontracts. The following MRD is superseded:

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94-OPD-052, 4 April 1994

14-200 Updates entire section based on 'lessons learned' and field recommendations. Stresses that the review of progress payment requests should be based on the strengths/weaknesses of the contractor's billing system internal controls. The following MRDs are superseded:

94-PFD-206, 23 November 1994

93-PAD-250, 20 December 1993

Chapter 15

15-105 Enhances guidance on preparing the NASA Form 456 - Notice of Contract Costs Suspended and/or Disapproved

Appendix A

A-200 Removes DAR, Section XV on the old contract cost principles. The majority of incurred costs subject to DAR have been audited and DAR is available in the FAO library, if needed.

Appendix B

Appendix B Updates entire Appendix based on 'lessons learned' and field recommendations. Incorporates concepts discussed in related DCAI training courses.

DCAA CONTRIBUTORS TO THIS EDITION

One of the primary sources for changes to improve the Contract Audit Manual (CAM) is suggestions from DCAA employees. As discussed in 0-007, it is very easy to make changes and all suggestions will be considered. The majority of the suggestions are submitted on the User Reply Sheet discussed in 0-007.

We thank the following individuals who made suggestions to improve this CAM edition:

Abernathy, Ann M.
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 Burlington Branch Office
 Western Regional Office
 Salt Lake Valley Branch Office
 Philadelphia Branch Office
 Harris Corporation Resident Office
 Seattle Branch Office
 Pasadena Branch Office
 Binghamton Branch Office
 Salt Lake Valley Branch Office
 Annandale Branch Office
 Oxnard Branch Office
 South County Branch Office
 Field Detachment
 Desert Valley Branch Office
 Field Detachment

Marten Marietta Technologies Resident Office
 Lockheed/Ft. Worth Resident Office
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0-000 INTRODUCTION TO THE DCAA CONTRACT AUDIT MANUAL

0-001 Introduction

Introductory material is presented in this section, along with an explanation of certain terms and abbreviations used frequently in this manual.

0-002 Purpose and Applicability of the Manual

a. This manual is issued to provide technical audit guidance, audit techniques, audit standards, and technical policies and procedures to be followed by DCAA personnel in the execution of the contract audit mission (see also 0-006). The material in this manual is instructive. Reference to this manual should not be made in audit reports or correspondence addressed to offices other than those of DCAA.

b. The procedural and audit guidance in the manual is applicable to the audit of all types of contracts. The auditor, however, must use professional judgment in (1) selecting the procedures and techniques best suited to the audit objectives, and (2) determining the scope of the audit in each instance.

0-003 Citation

The manual bears the title "DCAA Contract Audit Manual." It may be referred to as "CAM" and individual paragraphs may be cited as "CAM" followed by the paragraph number; for example, "CAM 1-103" but within the manual this citation would be "1-103."

0-004 Numbering

a. Pages are numbered at the top of the page as follows:

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Chapter Number (or Appendix Letter) _____
Page Number _____

b. Paragraphs are numbered as follows:

4-104

Chapter Number (Or Appendix Letter) _____
Section _____
Paragraph _____

Generally, paragraphs whose numbers include a decimal (as 1-203.1 through 1-203.4 are major, first-level subdivisions of the basic paragraph subject (as 1-203)).

0-005 Revisions

The manual is reprinted in its entirety on a semiannual basis in January and July. There are no interim revisions between printings. Each semiannual publication will contain a synopsis of new and/or revised material immediately following the Table of Contents.

0-006 Other DCAA Audit Guidance

Memorandums for Regional Directors (MRDs) provide a mechanism for disseminating audit guidance which supplements or revises CAM. Until incorporated in CAM, pertinent MRDs issued not less than three months preceding the publication date are listed by subject in the Keyword Index of Audit Guidance (AGKIS). In addition, an updated list of active audit guidance MRDs is issued quarterly. When using CAM, auditors should consult the AGKIS (TI-000) to identify any MRDs which may change guidance in the CAM text.

0-007 User Comments/Suggestions

User comments/suggestions are welcome. In addition, users are encouraged

to report any errors noted in the manual. Use DCAA Form 7640-15, User Reply Sheet, and send it to:

Headquarters, DCAA

Attention: Policy Formulation Division

Bldg 4, Cameron Station

Alexandria VA 22304-6178

The User Reply Sheet may also be sent by fax to (703) 617-7452 or by cc:Mail to *PFD.

0-008 Explanation of Terms and Abbreviations

DCAA—The Defense Contract Audit Agency.

Director—Director, DCAA.

Headquarters—Headquarters, DCAA.

DoD—The Department of Defense.

Regional office—The DCAA office having responsibility for all DCAA audit offices and auditors within a specified geographical area. Each is headed by a regional director and is the only organizational echelon between Headquarters and the field audit offices. Within each regional office, a particular regional audit manager exercises line authority over designated field audit offices.

Field audit office (FAO)—A DCAA term which encompasses both branch offices and resident offices. It does not include regional offices.

Resident office—The field audit office having responsibility for the DCAA mission, generally at one contractor location, and physically located at the contractor's plant.

Branch office—The field audit office having responsibility for the DCAA mission for all contractor locations in a designated area except those assigned to a resident office.

Auditor—An auditor performing the contract audit function of DCAA. Procurement liaison auditor (PLA)—A DCAA auditor assigned

responsibility for coordinating contract audit matters with a procurement or contract administration office.

Assignment Code—The smallest scope of audit review which may be separately programmed, including a five-digit identifier, a title and a scope statement or the five-digit number recognized by the DCAA FMIS as specifying a discrete audit scope.

Audit Area—A set of interrelated internal controls or elements of risk within one of the four major expense groupings.

Major Expense Grouping—An element of the contractor's cost accounting system. The four major groupings presently in use are: General Controls (accounting and estimating systems, balance sheet, and income accounts); Direct Labor; Direct Material; and Indirect Expense.

Subarea—An element of internal control or risk within an audit area. For example, the audit area E.1, Special Purpose Reviews within the major expense grouping Indirect Expense is further analyzed through the subareas Insurance, Pensions, Cost Allocation Bases, IR&D/B&P, and Other Audits.

Workpackage—Any combination of predefined scopes of work programmed separately on the FACS/MIS. It can include:

- * A single assignment code.
- * Two or more assignment codes.
- * An audit area or subarea (some subareas contain only a single assignment code).
- * A major expense grouping.
- * All direct costs or all indirect costs.
- * All costs included in the submission.

This manual also uses definitions stated in Federal Acquisition Regulation (FAR) and DoD FAR Supplement (DFARS) Part 202.

List of Acronyms and Abbreviations

A-E	Architect-Engineer
ACMS	Advanced Cost Management Systems
ACO	Administrative Contracting Officer
ACRS	Accelerated Cost Recovery System
AFAA	Air Force Audit Agency
AID	Agency for International Development
AICPA	American Institute of CPAs
AMIS	Agency Management Information System
ASBCA	Armed Services Board of Contract Appeals
B&P	Bid & Proposal
BCA	Board(s) of Contract Appeals
BOA	Basic Ordering Agreement(s)
CAC	Contract Audit Coordinator (DCAA)
CACO	Corporate/Home Office ACO
CACS	Contract Audit Closing Statement(s) (DCAA)
CAD/CAM	Computer-Aided Design & Manufacturing
CAIG	Cost Analysis Improvement Group (DoD)
CAM	Contract Audit Manual (DCAA)
CAS	Cost Accounting Standard(s)
CCDR	Contractor Cost Data Report(s)/ing
CECSR	Contractor Employee Compensation System Review
CFSR	Contract Funds Status Report(s)/ing
CFY	Contractor Fiscal Year
CHOA	Corporate Home Office Auditor (DCAA)
CIPR	Contractor Insurance/Pension Review
CO	Contracting Officer
COBOL	Common Business-Oriented Language (EDP)
COE	Corps of Engineers (Army)
CPA	Certified Public Accountant(s)
CPAF	Cost-Plus-Award-Fee (Contract)
CPFF	Cost-Plus-Fixed-Fee (Contract)
CPIF	Cost-Plus-Incentive-Fee (Contract)
CPR	Cost Performance Report(s)/ing
CPSR	Contractor Purchasing System Review
CPU	Central Processing Unit (EDP)
CRAI	Contractor Risk Assessment Guide
C/SCSC	Cost/Schedule Control System Criteria
CSRA	Civil Service Reform Act
CSSR	Cost/Schedule Status Report(s)/ing
CY	Calendar Year
DAC	Defense Acquisition Circular
DAR	Defense Acquisition Regulation
DCAAI	Defense Contract Audit Agency Instruction
DCAM	Defense Contract Audit Agency Manual
DCAAP	Defense Contract Audit Agency Pamphlet
DCAAR	Defense Contract Audit Agency Regulation
DCAI	Defense Contract Audit Institute
DCMAO	Defense Contract Management Area Operations
DCMC	Defense Contract Management Command
DCMD	Defense Contract Management District
DFARS	DoD Federal Acquisition Regulation Supplement
DHHS	Department of Health & Human Services
DIIS	DCAA Integrated Information System
DL	General Counsel (DCAA Hqs)

DLA	Defense Logistics Agency
DLAM	Defense Logistics Agency Manual
DODD	Department of Defense Directive
DODI	Department of Defense Instruction
DODIG	Department of Defense Inspector General
DOE	Department of Energy
DOJ	Department of Justice
DOL	Department of Labor
DOT	Department of Transportation
DPRO	Defense Plant Representative Offices
EAC	Estimate At Completion (Cost)
EDP	Electronic Data Processing (Computer(s))
EEO	Equal Employment Opportunity
EEOC	Equal Employment Opportunity Commission
EPA	Economic Price Adjustment
EPA	Environmental Protection Agency
ERISA	Employee Retirement Income Security Act (1974)
ESOP	Employee Stock Option Plan
ESS	Estimating System Survey
ETC	Estimate to Complete (Cost)
FAC	Federal Acquisition Circular
FAR	Federal Acquisition Regulation
FASB	Financial Accounting Standards Board
FAT	First Article Testing
FCR	Federal Contracts Report (BNA)
FCRC	Federal Contract Research Center(s)
FEMA	Federal Emergency Management Agency
FERC	Federal Energy Regulatory Commission
FFP	Firm-Fixed-Price (Contract)
FFRDC	Federally Funded R&D Center(s)
FICA	Federal Insurance Contributions Act
FLRA	Federal Labor Relations Authority
FLSA	Fair Labor Standards Act
FMIS	FAO Management Information System
FMS	Foreign Military Sales
FOUO	For Official Use Only
FPI	Fixed-Price Incentive (Contract)
FPR	Fixed-Price Redeterminable (Contract)
FPRA	Forward Pricing Rate Agreement(s)
FUTA	Federal Unemployment Tax Act
FY	Fiscal Year
G&A	General & Administrative (Expense)
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAC	Group Audit Coordinator (DCAA)
GAGAS	Generally Accepted Govt. Auditing Standards (GAO)
GAO	General Accounting Office
GASB	Governmental Accounting Standards Board
GBL	Government Bill of Lading
GFAE	Government-Furnished Aeronautical Equipment
GFM	Government-Furnished Material
GFP	Government-Furnished Property
GOCO	Government-Owned, Contractor-Operated (Plant)
GPO	Government Printing Office
GSA	General Services Administration
ICAPS	Internal Control Audit Planning Summary

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ICQ	Internal Control Questionnaire
IG	Inspector General
IIA	Institute of Internal Auditors
IPE	Industrial Plant Equipment
IR&D	Independent Research & Development (Cost)
IRC	Internal Revenue Code
IRS	Internal Revenue Service
JCL	Job Control Language (EDP)
JTR	Joint Travel Regulation
MAAR	Mandatory Annual Audit Requirement(s)
MICOM	U.S. Army Missile Command
MOU	Memorandum of Understanding
MRD	Memorandum for Regional Directors (DCAA)
MRP	Matl. Requirement Planning (Inventory Control Sys)
MWS	Major Weapon System
NASA	National Aeronautics and Space Administration
NGB	National Guard Bureau (DoD)
NRC	Nuclear Regulatory Commission
OAD	Special Audits Division (DCAA Hqs)
OAL	Audit Liaison Division (DCAA Hqs)
OFPP	Office of Federal Procurement Policy (OMB)
OIG	Office of the Inspector General
OMB	Office of Management and Budget
ONR	Office of Naval Research
OPD	Audit Programs Division (DCAA Hqs)
OPSEC	DoD Operations Security Program
OT	Manager, TSC
OWD	Workload and Trends Analysis Division (DCAA Hqs)
PACO	Principal ACO
PAD	Accounting Policy Division (DCAA Hqs)
PBIS	Performance Based Incentive System
PCO	Procuring Contracting Officer
PCD	Cost Accounting Standards Division (DCAA Hqs)
PDR	Plantwide Data Report
PFD	Policy Formulation Division (DCAA Hqs)
PI	Manager, DCAI
PL	Public Law
PLD	Policy Liaison Division (DCAA Hqs)
PNM	Price Negotiation Memorandum
POD	Program Objectives Document (DCAA)
PROCAS	Process Contract Administration Services (DLA)
PS&C	Production Scheduling & Control
R&D	Research & Development (Cost)
RAM	Regional Audit Manager
RD	Regional Director
RFP	Request(s) for Proposal(s)
SAS	Statement on Auditing Standards (AICPA)
SEC	Securities & Exchange Commission
SF	Standard Form
SIC	Suspected Irregular Conduct
SIS	Synopsis Information System(s) (DCAA)
T&M	Time and Material (Contract)
TBSR	Total Business System Review (ONR)
TCO	Termination Contracting Officer
TEFRA	Tax Equity and Fiscal Responsibility Act
TRASOPs	Tax Reduction Act Stock Ownership Plans

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■ TSC
U.S.C.
VAP
VLSI
W/P
WBS
WEARS
WRAP

Technical Services Center, Memphis
United States Code
Vulnerability Assessment Procedure(s) (DCAA)
Very Large Scale Integration
Working Papers
Work Breakdown Structure(s)
W/P Exhibits & Rate Schedules (DCAA)
Workpackage Risk Assessment Procedure (DCAA)

CHAPTER 1

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CHAPTER 1**1-000 INTRODUCTION TO CONTRACT AUDIT****1-001 Scope of Chapter**

This chapter introduces the chapters and appendixes which follow. It provides information on the contract audit mis-

sion; responsibilities of DCAA and the contract auditor; and the relationships of DCAA to other Department of Defense components, other government agencies, and contractors.

1-100 Section 1 — Establishment and Responsibilities of DCAA**1-101 Introduction**

This section describes the establishment, responsibilities, and inter-organizational relationship of DCAA.

1-102 Establishment and Responsibilities

a. The Defense Contract Audit Agency was established by a directive of the Department of Defense for the purpose of performing all contract auditing for the Department of Defense (DoD) and providing accounting and financial advisory services, in connection with the negotiation, administration and settlement of contracts and subcontracts, to all DoD procurement and contract administration activities. DCAA also furnishes contract audit service to other government agencies (see 1-302b.).

b. The role of the auditor is advisory, except that on cost-type contracts the auditor is required to comply with specific contract provisions. Procedures for such compliance are discussed in Chapter 6.

c. Although the detection of fraud or similar unlawful activity is not a primary function of contract audit, the auditor must constantly be alert for situations or transactions that may be indicative of such activity. When fraud or similar unlawful activity is suspected, the auditor shall be guided by 4-700.

1-103 Relationships — DCAA and the Office of the Secretary of Defense

DCAA is a separate agency of the Department of Defense under the direction, authority, and control of the Assis-

tant Secretary of Defense (Comptroller). Supplement 1-1S1 contains the Agency charter, DoD Directive 5105.36.

1-104 Nature of Contract Auditing**1-104.1 Introduction**

The following paragraphs state the objective of contract auditing and in broad terms how the objective is accomplished.

1-104.2 Contract Audit Objective

a. The purpose of contract auditing is to assist in achieving prudent contracting by providing those responsible for government procurement with financial information and advice relating to contractual matters and the effectiveness, efficiency, and economy of contractors' operations. Contract audit activities include providing professional advice on accounting and financial matters to assist in the negotiation, award, administration, repricing and settlement of contracts. Audit interest encompasses the totality of the contractor's operations, and reviews are performed to assure the existence of adequate controls which will prevent or avoid wasteful, careless, and inefficient practices by contractors. These reviews include the evaluation of a contractor's policies, procedures, controls and actual performance, identifying and evaluating all activities which either contribute to, or have an impact on, proposed or incurred costs of government contracts. Areas of concern to the auditor include the adequacy of contractor's policies, procedures, practices, and internal controls relating to accounting, estimating, and procurement; the evaluation of contractors' management policies and

decisions affecting costs; the accuracy and reasonableness of contractors' cost representations; the adequacy and reliability of contractors' records for government-owned property; the financial capabilities of the contractor; and the appropriateness of contractual provisions having accounting or financial significance. The auditor should recommend such changes as the examination discloses to be warranted. The terms "audit review" and "audit" refer to examinations by contract auditors of contractors' statements of costs to be incurred (cost estimates) or statements of cost actually incurred to the extent deemed appropriate by the auditors in the light of their experience with the contractors and relying upon their appraisals of the effectiveness of the contractors' policies, procedures, controls, and practices. Such audit reviews or audits may consist of desk reviews, test checks of a limited number of transactions, or examinations in depth at the discretion of the auditors.

b. To accomplish the objective of contract auditing, the auditor must examine or develop sufficient evidence to support a valid opinion of the extent to which costs or estimates contained in a contractor's claim or proposal are (1) reasonable as to nature and amount, (2) allocable, and measurable by the application of duly promulgated cost accounting standards, and (3) generally accepted accounting principles and practices appropriate to the particular circumstances; and (4) in accordance with applicable cost limitations or exclusions as stated in the contract or in FAR. The auditor will find it extremely useful at the onset of the examination, in planning the audit program and approach to review the contractor's accounting nomenclature, chart of accounts, accounting manuals and financial statements. It should, however, be recognized that professional opinions and conclusions on the acceptability of contract costs must be based on the auditor's knowledge of the contractor's classification practices and the actual nature of the expenditures charged to the various accounts and classifications. This knowledge is best gained by selective testing of transactions recorded in the various accounts.

c. The auditor should at all times be alert to any matters that may affect the government's prudent and efficient management of its procurement program. When the auditor becomes aware of the need for improved government practices, the appropriate office should be advised and, to the maximum extent feasible, the corrective measures should be recommended in the audit report.

d. In performing normal auditing procedures in connection with any type of examination, auditors should be alert for indications of excessive contract prices or profits and for evidence of overcharges or inadequate compensation to the government. If the auditor finds an indication of such a condition, he or she should discuss it with the supervisor to decide whether further review is warranted and whether the condition is properly reportable as one involving (1) suspected fraud or other similar irregularities (4-700); (2) defective pricing (14-100); or (3) solicitation of a voluntary refund (4-800). Guidance for determining which of the above reporting procedures should be used is contained in the referenced paragraphs. If the condition is not reportable under the foregoing guidance, a report stating the pertinent facts should nevertheless be submitted to Headquarters, DCAA, Attention: Deputy Assistant Director, Operations.

e. FAR 52.215-22 prescribes the insertion of a "defective pricing" clause which accords the government a contractual basis for reducing the contract price under certain conditions. When, after contract execution, it is learned that the contract price was negotiated on the basis of cost or pricing data furnished by the contractor that was incomplete, inaccurate or not current, the contracting officer may reduce the contract price. Guidance concerning the auditor's role in this area is stated in Chapter 14.

f. FAR 52.230-2 prescribes the insertion into contracts and subcontracts of a "cost accounting standards" clause which requires certain contractors or subcontractors to disclose in writing their cost accounting practices, to follow the disclosed practices consistently, to comply with duly promulgated cost accounting standards, and to agree to contract price

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adjustment for any increased cost to the government as a result of the contractor's failure to comply with applicable cost accounting standards. Guidance concerning the auditor's role with respect to cost accounting standards is stated in Chapter 8.

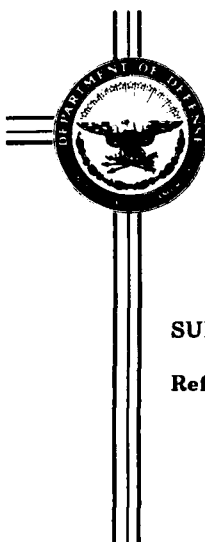
g. FAR 16.102(c) provides that the cost-plus-a-percentage-of-cost system of contracting shall not be used by the

government for any prime contract; or allowed to be used in any chain of cost or redeterminable subcontracts, unbroken by a firm fixed-price subcontract. If such a contract or subcontract is encountered, the entire cost, including the amount representing the percentage added, will be disapproved under cost-type contracts and recommended for nonacceptance under fixed-price redeterminable contracts.

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**1-1S1 Supplement — DoD Directive 5105.36 — Defense Contract Audit
Agency Charter**

(Updated through Change 1, 17 March 1983)



June 8, 1978
NUMBER 5105.36

ASD(C)

Department of Defense Directive

SUBJECT Defense Contract Audit Agency

References: (a) DoD Directive 5105.36, "Defense Contract
Audit Agency," June 9, 1965 (hereby cancelled)
(b) DoD Directive 5000.19, "Policies for the
Management and Control of Information
Requirements," March 12, 1976

[Text reformatted for CAM publica-
tion]

A. PURPOSE

Pursuant to authority vested in the Secretary of Defense under the provisions of title 10, United States Code, this Directive reissues reference (a) and establishes the Defense Contract Audit Agency (hereafter referred to as "DCAA") with responsibilities, functions, authorities, and relationships as outlined below.

B. MISSION

DCAA shall:

1. Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services will be provided in connection with nego-

tiation, administration, and settlement of contracts and subcontracts.

2. Provide contract audit service to other government agencies as appropriate.

**C. ORGANIZATION AND
MANAGEMENT**

1. DCAA is established as a separate agency of the Department of Defense under the direction, authority and control of the Assistant Secretary of Defense (Comptroller). It shall consist of a Director and such subordinate organizational elements as are established by the Director within resources authorized by the Secretary of Defense.

2. No separate contract audit organization independent of the DCAA shall be established in the Department of Defense.

**D. RESPONSIBILITIES AND
FUNCTIONS**

The Director, DCAA shall:

DCAA Contract Audit Manual

1. Organize, direct, and manage the DCAA and all resources assigned to the DCAA.

2. Assist in achieving the objective of prudent contracting by providing DoD officials responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate.

3. Audit, examine and/or review contractors' and subcontractors' accounts, records, documents and other evidence; systems of internal control; accounting, costing, and general business practices and procedures; to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in 4 through 12 below.

4. Examine reimbursement vouchers received directly from contractors, under cost-type contracts, transmitting those vouchers approved for payment to the cognizant Disbursing Officer and issuing DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with a copy to the cognizant contracting officer, with respect to costs claimed but not considered reimbursable. In addition, the contracting officer may direct the issuance of DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with respect to any cost which he has reason to believe should be suspended or disapproved.

5. Provide advice and recommendations to procurement and contract administration personnel on:

a. Acceptability of costs incurred under redeterminable, incentive and similar type contracts.

b. Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors incident to the award, negotiation, modification, change, administration, termination, or settlement of contracts.

c. Adequacy of financial or accounting aspects of contract provisions.

d. Adequacy of contractors' accounting and financial management systems, adequacy of contractors' estimating procedures and adequacy of property controls.

6. Assist responsible procurement or contract administration activities in their

surveys of the purchasing-procurement systems of major contractors.

7. Direct audit reports to the government management level having authority and responsibility to take action on the audit findings and recommendations.

8. Cooperate with other appropriate Department of Defense components on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices.

9. Establish and maintain liaison auditors as appropriate at major procuring and contract administration offices.

10. Review General Accounting Office reports and proposed responses thereto which involve significant contract or contractor activities for the purpose of assuring the validity of appropriate pertinent facts contained therein.

11. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings which contract cost matters, audit reports, or related financial matters are under consideration.

12. Provide assistance, as requested in the development of procurement policies and regulations.

13. Perform such other functions as the Assistant Secretary of Defense (Comptroller) may from time to time prescribe.

E. AUTHORITY

The Director, DCAA, is specifically delegated authority to:

1. Have free and unrestricted access to and direct communication with all elements of the Department of Defense and other executive departments and agencies as necessary.

2. Establish Defense Contract Audit Agency facilities using appropriate established physical facilities and services of other DoD components whenever practicable to achieve maximum efficiency and economy.

3. Obtain such information, consistent with the policies and criteria of DoD Directive 5000.19, (reference (b)) advice, and assistance from DoD components as he deems necessary.

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4. Exercise the administrative authorities contained in enclosure 1 of this Directive.

F. RELATIONSHIPS

1. In the performance of his functions, the Director, DCAA shall:

a. Maintain appropriate liaison with other components of the DoD, other agencies of the Executive Branch, and the General Accounting Office for the exchange of information and programs in the field of assigned responsibilities.

b. Make full use of established facilities in the Office of the Secretary of Defense, other DoD components, and other governmental agencies rather than unnecessarily duplicating such facilities.

c. The military departments and other DoD components shall provide support, within their respective fields of responsibility, to the Director, DCAA to assist in carrying out the assigned responsibilities and functions of the Agency. Programming, budgeting and financing for such support will be in accordance with policies and procedures prescribed by the Assistant Secretary of Defense (Comptroller).

2. Procurement and contract administration activities of the DoD components shall utilize audit services of the DCAA to the extent appropriate in connection with the negotiation, administration, and settlement of contract payments and prices which are based on cost (incurred or estimated), or on cost analysis.

G. ADMINISTRATION

1. The Director, DCAA, shall be a civilian selected by the Secretary of Defense.

2. The appointment of other personnel to the Agency will be subject to the approval of the Director, DCAA.

3. DCAA will be authorized such personnel, facilities, funds, and other administrative support as the Secretary of Defense deems necessary.

H. EFFECTIVE DATE

This Directive is effective immediately.

Deputy Secretary of Defense

Enclosure - 1
Delegations of Authority

Encl. 1, DoD Instruction 5105.36 DELEGATIONS OF AUTHORITY

Pursuant to the authority vested in the Secretary of Defense, and subject to his direction, authority, and control, and in accordance with DoD policies, directives, and instructions, the Director, DCAA, or, in the absence of the Director the person acting for him, is hereby delegated authority as required in the administration and operation of DCAA to:

1. Exercise the powers vested in the Secretary of Defense by 5 U.S.C. 301, 302(b) and 3101 pertaining to the employment, direction and general administration of DCAA civilian personnel.

2. Fix rates of pay for wage board employees exempted from Civil Service classification by 5 U.S.C. 5102(c)(7) on the basis of prevailing rates for comparable jobs in the locality where each installation is located.

3. Establish advisory committees and employ part-time advisers pursuant to the provisions of 10 U.S.C. 173, 5 U.S.C. 3109(b), the Federal Advisory Committee Act, and the Agreement between the Department of Defense (DoD) and the Civil Service Commission on employment of experts and consultants, dated March 14, 1975.

4. Administer oaths of office incident to entrance into the Executive Branch of the Federal Government or any other oath required by law in connection with employment therein, in accordance with the provisions of 5 U.S.C. 2903, and designate in writing, as may be necessary, officers and employees of DCAA to perform this function.

5. Establish a DCAA Incentive Awards Board and pay cash awards to, and incur

necessary expenses for the honorary recognition of civilian employees of the government whose suggestions, inventions, superior accomplishments or other personal efforts, including special acts or services, benefit or affect DCAA or its subordinate activities in accordance with the provisions of 5 U.S.C. 4503 and Civil Service Regulations.

6. In accordance with the provisions of 5 U.S.C. 7532; Executive Order 10450, dated April 27, 1953, as amended; and DoD Directive 5210.7, "Department of Defense Civilian Applicant and Employee Security Program," September 2, 1966:

a. Designate any position in DCAA as a "sensitive" position;

b. Authorize, in case of an emergency, the appointment of a person to a sensitive position in the Agency for a limited period of time for whom a full field investigation or other appropriate investigation, including the National Agency Check, has not been completed; and

c. Authorize the suspension, but not to terminate the services of an employee in the interest of national security in positions within DCAA.

7. Clear DCAA personnel and such other individuals as may be appropriate for access to classified Defense material and information in accordance with the provisions of DoD Directive 5210.8, "Policy on Investigation and Clearance of DoD Personnel for Access to Classified Defense Information," February 15, 1962, and of Executive Order 11652, dated March 8, 1972, as amended.

8. Act as agent for the collection and payment of employment taxes imposed by Chapter 21 of the Internal Revenue Code of 1954 and, as such agent, make all determinations and certifications required or provided for under Section 3122 of the Internal Revenue Code of 1954 and Section 205(p)(1) and (2) of the Social Security Act, as amended (42 U.S.C. 405(p)(1) and (2)) with respect to DCAA employees.

9. Authorize and approve overtime work for DCAA civilian officers and employees in accordance with the provisions of the Federal Personnel Manual Supplement 990-1, Section 550.111.

10. Authorize and approve:

a. Travel for DCAA civilian officers and employees in accordance with Joint Travel Regulations, Volume 2, DoD Civilian Personnel;

b. Temporary duty travel only for military personnel assigned or detailed to DCAA in accordance with Joint Travel Regulations, Volume 1, Members of Uniformed Services; and

c. Invitational travel to persons serving without compensation whose consultative, advisory or other highly specialized technical services are required in a capacity that is directly related to, or in connection with DCAA activities, pursuant to the provisions of 5 U.S.C. 5703.

11. Approve the expenditure of funds available for travel by military personnel assigned or detailed to DCAA for expenses incident to attendance at meetings of technical, scientific, professional or other similar organizations in such instances where the approval of the Secretary of Defense or his designee is required by law (37 U.S.C. 412). This authority cannot be redelegated.

12. Develop, establish and maintain an active and continuing Records Management Program, pursuant to the provisions of Section 506(b) of the Federal Records Act of 1950 (44 U.S.C. 3102), the Freedom of Information Act Program (5 U.S.C. 552) and the Privacy Act Program (5 U.S.C. 552a).

13. Establish and use Imprest Funds for making small purchases of material and services other than personal for DCAA when it is determined more advantageous and consistent with the best interests of the government, in accordance with the provisions of DoD Instruction 5100.71, "Delegation of Authority and Regulations Relating to Cash Held at Personal Risk Including Imprest Funds," March 5, 1973, and the Joint Regulation of the General Services Administration/Treasury Department/General Accounting Office, entitled "For Small Purchases Utilizing Imprest Funds."

14. Authorize the publication of advertisements, notices or proposals in newspapers, magazines or other public periodicals as required for the effective administration and operation of DCAA (44 U.S.C. 3702).

15. Establish and maintain appropriate Property Accounts for DCAA and appoint Boards of Survey, approve reports of survey, relieve personal liability, and drop accountability for DCAA property contained in the authorized Property Accounts that has been lost, damaged, stolen, destroyed or otherwise rendered unserviceable, in accordance with applicable laws and regulations.

16. Promulgate the necessary security regulations for the protection of property and places under the jurisdiction of the Director, DCAA, pursuant to subsections III.A. and V.B. of DoD Directive 5200.8, "Authority of Military Commanders under the Internal Security Act of 1950 to Issue Security Orders and Regulations for the Protection of Property or Places under Their Command," August 20, 1954.

17. Establish and maintain, for the functions assigned, an appropriate publi-

cations system for the promulgation of common supply and service regulations, instructions, and reference documents, and changes thereto, pursuant to the policies and procedures prescribed in DoD Directive 5025.1, "Department of Defense Directive System," November 18, 1977.

18. Enter into support and service agreements with the Military Departments, other DoD agencies, or other government agencies as required for the effective performance of responsibilities and functions assigned to DCAA.

The Director, Defense Contract Audit Agency, may redelegate these authorities, as appropriate, and in writing, except as otherwise specifically indicated above or as otherwise provided by law or regulation.

This delegation of authorities is effective immediately.

1-200 Section 2 — Relationships with the General Accounting Office**1-201 Introduction**

This section contains procedures and guidance on (1) granting the General Accounting Office access to DCAA audit records and files, (2) submitting information and comments to Headquarters for preparing replies to General Accounting Office (GAO) reports, (3) coordinating DCAA and GAO activities to ensure effective working relationships, and (4) coordinating DCAA and GAO performance of postaward audits of cost or pricing data for possible defective pricing.

1-202 Relationship — DCAA and General Accounting Office

a. The GAO has broad authority for conducting audits and investigations to enable the Comptroller General, as an agent of Congress, to determine whether executive departments and government agencies properly discharge their financial responsibilities. In connection with the audit of the procurement function, the GAO is granted access to contractors' records by law and by contract provisions. DoD personnel at all levels will cooperate fully with representatives of the General Accounting Office.

b. The Policy Liaison Division (PLD) monitors and coordinates all GAO matters in accordance with DoDD No. 7650.3, Followup on General Accounting Office, DoD Inspector General, Internal Audit, and Internal Review Reports; No. 7650.1, General Accounting Office Access to Records; and No. 7650.2, General Accounting Office Audits and Reports.

1-203 GAO Access to Audit Records and Files

a. When requested by GAO furnish audit reports and associated working papers in accordance with DoDD 7650.1, General Accounting Office Access to Records, and DCAAR Number 5205.1, DCAA Information Security Program, and the procedures below. Advance approval of regional offices or Headquarters

is not required, provided that the GAO has notified the Secretary of Defense and DCAA of the review and held an entrance conference with DoD officials.

b. Do not furnish non-DoD agency reports, military department reports, non-DoD Inspector General reports, or criminal investigation organization reports (including the FBI) unless approved by DCAA Headquarters. This restriction also applies to summaries of such reports.

c. Promptly submit pertinent information to the regional office and Headquarters, Attn: PLD. Identify the information furnished to GAO.

1-203.1 Access to Audit Records and Files on Completed Audits

a. When requested, grant GAO representatives unlimited access to audit records and files applicable to completed audits. This includes access to files on all types of system surveys, audit programs, working papers, correspondence on cost allowances, notices of cost suspended or disapproved, contracts, and audit reports.

b. Cooperate with GAO representatives by providing copies of existing documents and, to a reasonable extent, completing questionnaires. Refer GAO requests for data which require the preparation of extensive analyses or schedules to Headquarters, Attn: PLD.

c. Encourage the GAO representatives to perform their analytical effort on site, both to minimize the use of DCAA resources and to enable the auditor to explain or clarify data if required.

1-203.2 Access to Audit Records and Files on Incomplete Audits

Resolve requests for access to records and files applicable to incomplete audits with the GAO representatives on an individual case basis. Make every effort to dissuade the GAO representative from examining records and files on incomplete audits, because any audit conclusions included therein are tentative. They do not represent the official position of DCAA until the audit is completed and

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the report issued. This does not preclude granting the GAO access to any factual data contained in the records or files.

1-203.3 Access to Records on Replies to GAO Reports

Refer GAO requests for access to copies of correspondence or memorandums prepared to assist DCAA Headquarters and military departments or agencies in the formulation of an official reply to a GAO draft report or final report to Headquarters, Attn: PLD. This information requires special consideration because it does not represent the final position of DCAA or the military department or agency concerned with the report.

1-204 Replies to General Accounting Office Reports

a. GAO reporting on defense contracting is primarily accomplished through (1) reports (draft and final) issued by its headquarters office and addressed to the Secretary of Defense, the Secretaries of the Military Departments, or heads of Defense agencies; (2) letter reports issued by GAO regional offices directly to officials of field activities of the Military Departments or DoD agencies, and (3) congressional testimony.

b. DCAA will generally be requested to submit comments and participate in formulating the official DoD position on the cost aspects and related recommendations in GAO reports issued on defense contractors and on contract audit matters.

1-204.1 Replies to GAO Headquarters Reports

a. These reports generally pertain to defense contracting. They are initially submitted in draft form with a request for an official response and comments. The response is usually incorporated in the final GAO report.

b. The Office of the Assistant Inspector General for Audit Followup refers all proposed DoD responses to GAO Headquarters reports related to procurement or contract audit matters to DCAA Headquarters for concurrence or comment

prior to approval for signature elsewhere in the Department of Defense.

c. In advance, Headquarters (PLD) reviews GAO reports that may require comment and will immediately transmit the report to the regional office(s) and FAO(s) involved if field action or input is required. Prepare the field office response in accordance with paragraph d. below and any special requests stated in the Headquarters transmittal.

d. Review and evaluate the factual information, the surrounding circumstances, and the conclusions presented in the report. Comment on any corrective action taken or proposed. In addition, note any GAO report statements that are not fully compatible with audit findings or on which information is not available. To minimize elapsed time, conferences with the GAO review team may be necessary. In this case, make an appropriate request to the local GAO office or to Headquarters, Attn: PLD, depending on the origin of the GAO report.

e. In some cases the primary action office requests Headquarters to perform audits or examine specific contractor records to aid in formulating the DoD position on a GAO report. In these instances, Headquarters will establish a firm due date for the response and forward the request directly to the field audit office, with copies to the regional office. Submit the field audit office's reply to Headquarters, Attn: PLD, with a copy to the regional office.

f. Field audit offices may receive direct requests from procurement or contract administration field components for audit service on specific GAO reports. Promptly forward copies of all correspondence, memorandums of conversations, and reports prepared in response to such requests to Headquarters, Attn: PLD, with copies to the cognizant regional office.

1-204.2 Replies to Letter Reports of GAO Regional Offices

a. GAO regional offices may issue letter reports on defense contracting directly to officials of field activities of DoD agencies or the military departments. Letter reports include any written communication from GAO requiring

written response. These reports generally relate to matters of less significance than GAO Headquarters reports. They are addressed to the particular field activity responsible for the matters reported upon or for the implementation of any recommendations contained in the report. Thus, letter reports may be addressed to field procurement or contract administration offices or to DCAA field offices.

b. Prepare responses to GAO letter reports for the signature of the regional director. To assure uniformity in responses and conformity with DCAA policy, submit drafts of the proposed responses to Headquarters, Attn: PLD, for concurrence prior to issuance. When necessary to meet a deadline, concurrence of Headquarters (PLD) may be obtained by telephone.

c. FAOs may receive requests directly from a field procurement or contract administration office for audit information in connection with their responses to letter reports which were addressed to them. Honor such requests pertaining to contract audit responsibility. Prepare the response for the regional director's signature and reply directly to the requesting activity. Forward copies of all correspondence and reports prepared in response to such requests to Headquarters, Attn: PLD.

1-204.3 Congressional Testimony

GAO also reports on defense contracting through testimony presented before Congress. Occasionally DCAA Headquarters is requested to review the testimony in advance for factual accuracy and concurrence. These requests often have a short response time, and regional or field office input is usually not feasible.

1-204.4 Explanations of Delays in Submission of Responses to GAO Reports

Promptly submit an interim reply to Headquarters, DCAA, with a copy to the regional office, when a complete response cannot be submitted by the established due date. State the specific reasons the due date cannot be met and the estimated time needed to complete the review. Address as many of the report findings,

conclusions, and recommendations as possible.

1-205 Liaison Between DCAA and GAO Activities

Maintain formal and informal liaison between DCAA and GAO at the headquarters and/or regional office levels to establish an effective working relationship. This is not intended to diminish or detract from the statutory and executive responsibilities, functions, or independence of either GAO or DCAA.

1-205.1 Headquarters Liaison

Maintain direct headquarters-to-headquarters liaison between DCAA and GAO to (1) resolve field operating problems requiring Headquarters attention, (2) coordinate studies to be performed by GAO affecting the contract audit area, and (3) exchange ideas and training material in connection with improving the performance of the two agencies.

1-205.2 Regional Office Liaison

a. Determine the level and frequency of communication with GAO regional officials by assessing local conditions and GAO involvement in contract audit matters. Regional directors should decide on the need for local conferences (see 1-205.3) and periodically visit or contact GAO representatives located within their regional boundaries to explore the need for more formal information exchange. Periodic meetings are encouraged to resolve specific problems and to discuss the results of individual GAO reviews of contractor activities containing significant contract audit findings.

b. In those cities where GAO has a regional office and DCAA does not, designate a branch manager or resident auditor as a DCAA regional liaison representative to provide a local contact point to facilitate day-to-day working relationships and to resolve problems.

c. Submit a copy of the minutes of any formal liaison meeting to Headquarters, Attn: PLD.

1-205.3 Regional Conferences with GAO

a. Regional directors are encouraged to schedule periodic conferences to promote

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free and open discussions between GAO and DCAA at the regional level. Conferences should cover current items of common interest, such as plans for added or decreased emphasis in specified areas of responsibility, technical problems, audit approaches and techniques, and working relationships. Conference objectives should be to identify and resolve common problems, avoid duplication, and improve audit techniques and coverage.

b. Where more than one GAO regional office is located within the geographical jurisdiction of a DCAA regional office, encourage all of the GAO regional directors concerned to attend the conference, unless the GAO region is not significantly involved with contract audit work. Similarly, where the geographical jurisdiction of a GAO regional office overlaps DCAA regions, it may be appropriate for DCAA regional directors to attend conferences held by other DCAA regional directors.

c. Submit a copy of the minutes of any formal liaison conference to Headquarters, Attn: PLD.

1-205.4 Liaison on GAO Reviews Affecting DCAA

a. Except for congressional requests, GAO regional directors are expected to inform DCAA of the scope of GAO planned and in-process reviews concerning contractors under DCAA audit cognizance. GAO generally contacts DCAA at the start of every review, conducts an exit conference at the end of such reviews, and furnishes a copy of the draft and/or final report.

b. When GAO is involved in reviews of DCAA or in audits at contractor plants under DCAA cognizance, work closely with GAO to assure that there is proper understanding of DCAA objectives and methods to avoid GAO duplication of our work and to determine reliance to be placed upon the work of GAO (see 4-1000).

c. Notify the regional office and Headquarters, Attn: PLD, of any GAO visits to FAOs or contractor sites.

1-206 Interface with GAO in the Performance of Defective Pricing Audits

DCAA is the responsible DoD agency for establishing and conducting a pro-

gram for performing regularly scheduled audits of contractor cost or pricing data for possible defective pricing (14-100). GAO responsibilities include DoD's adherence to applicable laws, regulations, and procedures in negotiating noncompetitive contracts, including whether defective pricing audits are adequately performed. Observe the following procedures whenever GAO has an interest in the cost or pricing data submitted for negotiation of a contract or subcontract.

1-206.1 Postaward Audit Already Performed by FAO

Provide the results of the audit to the GAO representatives on request, per 1-203.

1-206.2 Postaward Audit not Completed by FAO

DCAA has the primary responsibility for performing defective pricing audits. Therefore, GAO will coordinate its contract and subcontract defective pricing audit work with cognizant field audit offices and rely on the contract auditor's work where possible. Avoid duplication of audit effort by following the procedures below:

a. If the FAO has a postaward audit scheduled that is of interest to GAO, discuss the audit plans with GAO and attempt to reach agreement on an audit schedule which provides for audit performance by DCAA. Eliminate the contract or subcontract from the audit schedule if agreement cannot be reached and the GAO performs the audit. In these situations, GAO is expected to perform a defective pricing audit of all contract cost elements. Promptly notify the regional office and Headquarters, Attn: PLD, if GAO plans to perform only a partial review.

b. If the GAO identifies a contract or subcontract for postaward audit which had not been selected for audit by DCAA, attempt to reach agreement on an audit schedule which provides for audit performance by DCAA.

1-300 Section 3 — Audit Services for Non-DoD Agencies**1-301 Introduction**

This section provides guidance for performing audit services for non-DoD agencies. The underlying audit policies, procedures, and support requirements pertaining to such services are presented in 15-100.

1-302 General Rules for Establishing Cognizance and Accepting or Rejecting Non-DoD Requests

a. Office of Management and Budget (OMB) Circular A-73, "Audit of Federal Operations and Programs" (revised), requires Federal agencies to establish audit cross-servicing arrangements when doing so is in the best interest of the Federal government and the organization being audited. Normally, the agency with the predominant financial interest should arrange for all audits at an organization. Department of Defense implementing guidance is provided by DoDD 7600.2, "Audit Policies." Thereunder, contract audit services may be provided to other Federal agencies upon request, with reimbursement at cost, as prescribed by the Assistant Secretary of Defense (Comptroller).

b. Cross-servicing arrangements have been made through memorandums of understanding (MOU) with various non-DoD agencies under the OMB criteria and DoD implementing guidance.

c. There are many Federal agencies with which DCAA has not established MOUs or had any contact concerning audit cognizance. Should DCAA auditors become aware of contract audit effort being performed by or on behalf of other Federal entities at contractor locations where DCAA is the cognizant contract audit agency, they should advise DCAA Headquarters, Attention: OAD, through their regional offices.

d. Any non-DoD agency request concerning a change in audit cognizance or related matters should be addressed to DCAA Headquarters, Attention: OAD.

e. DCAA is responsible for determining the scope of audit, including the

manner and level of effort necessary to provide complete contract audit coverage at a contractor location. The Contract Audit Manual will be the determining guide for the conduct of audits. Complete contract audit coverage may include reviews of internal controls and examinations of contractor accounting and financial management systems considered necessary to satisfy government auditing standards, as incorporated in OMB Circular A-73, Section 6. When possible, auditors should be responsive to any additional coverage suggested by the requesting agency.

f. Audit working papers prepared during the course of audits for Federal agencies are the property of DCAA and will generally remain in the possession of the auditor. However, they will be made available for review by properly authorized procurement and other representatives of the Federal agencies for which the audit services were performed. If audit cognizance is transferred from DoD to another Federal agency, audit files may be released to the successor agency if (1) the files are no longer required by DCAA, (2) the files will benefit the agency in carrying out its audit responsibilities, and (3) there are no restrictions on the release of the files, e.g., SIC and classified. FAOs should keep a record of files transferred. Audit folders or other documents which are still required by DCAA may be copied by the successor agency provided they meet the above criteria. However, prior to the actual transfer of audit files, the instructions contained in DCAAM 5015.1 Chapter 4, paragraph B.3, must be followed.

g. Audit reports will be addressed in the manner prescribed in 10-208.

h. The auditor's responsibility for attending negotiation conferences requested by non-Defense procurement officials is essentially the same as that outlined in 15-400 for Defense procurement officials. The auditor will also be responsive to inquiries and personal visits from representatives of non-Defense agencies concerning the status and performance of

requested audits. The objectives of such personal visits should be to seek information and to discuss mutual problems. They are not to be used to supervise and/or evaluate the performance of the audit.

i. Responsibility for follow-up of DCAA audit recommendations and reviews of program results remain with the non-DoD agencies for which audit services are performed.

j. Field activities will prepare reimbursable billings in accordance with the requirements of the DCAA FMIS User Manual, Volume II, Section III-E2.

1-303 Processing Non-DoD Agency Requests for Audit Information or Services

a. DCAA will be responsive to requests received from government agencies outside the Department of Defense for information available in the audit files when the circumstances clearly show that the inquirer is entitled to the requested information. There is a presumption of entitlement if the requesting agency has a contract or is proposing to contract with the contractor and the information desired is related to the negotiation or administration of that contract. Requests for specific cost information which is readily available without audit effort will be accommodated without reimbursement. If the auditor has any doubt as to whether the requesting agency is entitled to the information, the auditor must obtain clearance from the contractor before releasing any specific cost or financial data, such as overhead rates. A request for cost or financial data, written material, or access to working papers or audit files by a non-Defense agency, except for the Internal Revenue Service, which pertains to a matter (except an investigation or litigation) unrelated to the negotiation or administration of a contract by the requesting agency, will be referred to Headquarters, Attention: PLD, for consideration. The referral will include all pertinent details, such as the names of the representatives involved, a summary of the information requested, purpose of the request, a summary of any

discussions held with respect to the information desired, and any other pertinent observations. See 1-406 for guidance when requests by a non-Defense agency pertain to a matter involving an investigation or litigation; see 1-408 for all requests by the Internal Revenue Service.

b. Cross-servicing agreements with non-DoD agencies provide for audit requests to be forwarded directly to the cognizant field office. Audit requests will be honored at locations where DCAA maintains a continuing audit interest under DoD contracts.

c. A request for audit services to be performed at a contractor location where DCAA does not have a continuing audit interest is considered a "casual audit request." A continuing DCAA audit interest exists at any location where DCAA has performed audit effort on a continuing basis over the past several years, whether the contracting agency is affiliated with DoD/NASA or not.

d. Except for those agencies identified in DCAAP 7230.1, Reimbursable Audit Program Manual, requests for audit services at locations where DCAA does not maintain a continuing audit interest will be referred to the regional office. Seasoned professional judgment and common sense must be applied to each casual audit request in making a decision as to whether or not to accept the audit engagement. The following criteria will be used to determine whether to accommodate or decline a request:

(1) Is the requested service compatible with normal DCAA responsibilities?

(2) Would acceptance or refusal to perform the work result in establishment of duplicative audit activity?

(3) Is another government agency performing audit work at the contractor location that could perform the requested audit?

(4) The extent and cost of DCAA TDY travel that would be required to honor a casual audit request should be a key factor. If honoring the request would require the incurrence of TDY travel time and costs, it may be just as efficient for the requesting agency to make other audit arrangements. In addition, if the requesting agency maintains a local audit

organization, rejection may well be the appropriate response.

(5) It is important to consider the type of audit being requested and the contract audit capabilities of the requesting agency. For example, if the request is for review of a price proposal, we should consider the nature of the proposed services or products, the urgency of the procurement, and the ability of the requesting agency to arrange for adequate timely contract audit service.

A regional determination that a casual audit request should be declined will be coordinated with Headquarters, Attention: OAD.

e. When an auditor observes the presence of non-DoD contracts subject to audit coverage for which audit requests have not been received, they will be brought to the attention of appropriate non-DoD agency officials, to facilitate issuance of requests for audit.

f. Regional offices will notify Headquarters, Attention: OAD, of audit requests from non-DoD agencies not identified in the FMIS User Manual, Appendix C, Billing Source Codes. Such requests must be processed promptly, since

the requesting agency will need to make other arrangements if DCAA does not agree to accept the engagement. Typically, such work will be accepted if the audit effort falls within the normal scope of DCAA work and the requesting agency agrees to pay for the audit effort. Headquarters will decide whether the additional work will be undertaken and will notify the requesting organization and field office accordingly.

g. All audit requests should be promptly responded to in writing. The response should state whether DCAA will accommodate or decline the request. If the request is declined, the reasons should be stated. If the request is accepted, the response should include the anticipated audit report date.

h. Based on prior agreements, DCAA will perform all contract audit work requested by NASA. DCAA has also agreed to perform contract audit work at all DOE prime contractor locations other than those designated as Management and Operating Prime Contractors. DCAA will also perform all audit effort assigned to DoD under OMB Circular A-88.

1-400 Section 4 — Relationships with Other Government Organizations

1-401 Introduction

This section provides guidance and procedures governing relationships with other government organizations.

1-402 General

Other government personnel may communicate with DCAA personnel on official business. In all cases, the identity of the individual and his or her need to know should be established prior to furnishing any information either written or oral. Appropriate security precautions should be observed with respect to both classified military information and contractor information.

1-403 Relationships with DoD Procurement and Contract Administration Organizations

1-403.1 DCAA to Procurement and Contract Administration Organizations

a. As the audit and financial advisor to procurement and contract administration activities, auditors must understand and support the service needs of these organizations. DCAA is committed to providing timely and responsive services and will maintain communications and liaison services sufficient to continuously assess if customer needs are being met.

b. Organizationally, DCAA is separate and independent from acquisition components of the DoD. Auditors are expected to exercise independent judgment in planning the type and extent of audit testing sufficient to render unqualified audit opinions, but will consider and address special areas of concern or informational needs of requestors. The auditor will also exercise independence in the formulation of audit opinions, recommendations, and conclusions contained in audit reports.

c. Government interests can best be served by maximum cooperation and exchange of useful information between audit and procurement personnel. DoD Directive 7600.2 requires that DCAA coordinate annual contract audit plans

with procurement and contract administration organizations. In addition, effective liaison between the DCAA auditor and the contracting officer's representatives, and a clear understanding of the respective responsibilities of each in the overall procurement function, are essential to ensure continuous close cooperation.

d. Regulations of the military departments and DLA require the contracting officers' representatives to use advisory audit services to the fullest extent practicable and to aid audit performance by furnishing the auditor with appropriate administrative and technical assistance. Appendix D-200 of this manual refers to the procedures whereby the auditor obtains technical assistance and guidance which may be required in the evaluation of a contractor's proposal. For those contractor locations where there is a significant and continuing volume of audit workload, e.g., audit residency or suboffice, the auditor should establish an effective working relationship with the major field contract administrators to keep each other informed on procurement and audit matters including forthcoming contractor proposals which will require audit services.

1-403.2 Procurement and Contract Administration Responsibilities to DCAA

Procurement and contract administration personnel have responsibility for the following:

a. Requesting contract audit service.

b. Providing sufficient time for the performance of the audit.

c. Furnishing to the auditor, in connection with a request for audit, copies of any contracts (including change orders, supplements, amendments, and termination notices), cost statements, proposals, and other financial data submitted by contractors or, as appropriate, requested by the auditor.

d. Establishing access to contractor records required by auditors.

e. Furnishing such other information, data, or service as may be required (such

as technical evaluation of the need for the quantity and type of labor and material proposed in contract pricing actions) or otherwise may be useful in performing the audit.

1-403.3 Major Audit Issues

DCAA Form 1 as well as audit report recommendations may lead to disagreements between the auditor and the contracting officer. There must be continual and timely communication between the parties to promote understanding and improve the potential for satisfactory resolution of the issue before final contracting officer action. Verbal communications involving major audit issues should be followed up in writing to avoid misunderstandings.

1-403.4 DCAA Participation on Contract Management Boards of Review

a. Nature of Review Boards

Review Boards are established to examine proposed contract actions for all contract administration functions on an ad hoc basis. For example, review boards may be established to evaluate the reasonableness of proposed settlements or determinations concerning contractor purchasing system reviews (CPSR), contract terminations, and Cost Accounting Standards issues. The District Commander is responsible for the establishment of review boards for each Defense Contract Management District (DCMD). In addition, the District Commander may establish subordinate Boards of Review at individual Defense Contract Management Area Operations (DCMAO) or Defense Procurement Offices (DPRO).

b. Restrictions on Auditor Participation

Auditor participation in review board activities has proven beneficial in many instances. Such participation is normally performed as a non-voting advisory service. Continued efforts of this type are encouraged subject to the following restrictions.

(1) DCAA personnel shall not participate as members of review boards when they are engaged in matters related to the resolution of audit report recommendations. DCAA participation on the board

in such cases might discourage the board from requesting assistance from field personnel most capable of answering questions pertaining to a specific audit recommendation.

(2) No DCAA auditor will serve as a member of a board while it is reviewing a contract action with which he or she was previously associated as a contract auditor, supervisor, or participant in negotiation conferences. Where this situation occurs, another auditor should be appointed.

c. Processing Requests for Participation

(1) Requests may be received by Headquarters, regional offices, or field audit offices to furnish audit personnel to participate on review boards. The Assistant Director, Operations, is responsible for action on requests for board participation by Headquarters personnel. The cognizant regional director is responsible for action on requests for board participation by regional office and FAO personnel.

(2) Upon receiving a request to furnish audit personnel to participate on review boards, first obtain information concerning the functions of the board, the estimated periods of participation of DCAA personnel, the estimated amount of time required on a weekly or monthly basis, and the benefit to the government of DCAA participation. Requests received by FAOs will then be promptly forwarded to the regional office with the name of the auditor recommended for membership.

(3) Tactfully decline any request for participation which would frequently require auditor abstentions or substitutions to avoid a restriction in b. above. Where any other request cannot be complied with by the region, contact the Assistant Director, Operations, before notifying the requesting office.

(4) When a request for participation is accepted, the DCAA response will set forth the arrangements for and restrictions, if any, on auditor participation.

1-404 Relationship with Government Internal Audit Organizations

1-404.1 Organization for Government Internal Audit

a. The DoD Inspector General is responsible for DoD level internal and

11-404.1a.

oversight audits and investigations. Responsibilities of the DoD IG include (1) evaluating activities relating to contract audits; (2) investigating fraud, waste, and error; (3) monitoring adherence to contract audit principles, policies, and procedures; and (4) monitoring actions taken by DoD components in response to contract audits. The various Military Services also have internal audit groups that perform internal audits for their respective DoD component.

b. Internal audit, oversight, and investigative services are performed by the offices of the Assistant DoD IGs for (1) Auditing, (2) Audit Policy and Oversight, (3) Analysis and Followup, (4) Investigations/DCIS, and (5) Inspections. DoD component internal audit organizations include the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency. Most non-DoD agencies have similar activities for the performance of internal audit within their organizations. The following guidance also applies to non-DoD agencies.

1-404.2 DCAA Assistance to Government Internal Audit Organizations

a. When internal audits require verification of contractor data or records at contractors' plants, the internal audit organization normally will obtain fact-finding assistance from DCAA.

b. Support will be furnished to the internal auditor where doing so does not conflict with the contract auditor's basic role of providing advisory services to contracting officers. Requests requiring contract auditors to evaluate contracting officers' performance are inappropriate, whereas assistance concerning contractors' performance is appropriate.

c. Contract audit working papers, reports, and files will be made available to internal auditors in their audits of procurement, contract administration, or related functions provided DCAA has received written notice of the objective and the scope of the internal audit review.

d. If the data or information required by the internal auditor are not available in contract audit files, DCAA may be requested to provide assistance. These requests will be honored when feasible

and mutually agreeable. Written confirmation of the request for audit assistance will be furnished to the internal auditor within seven working days of receipt. When DCAA is unable to render requested assistance, the DoD audit representatives shall make arrangements to perform the necessary audit work themselves.

e. Internal auditors will not be precluded from reviewing contractors' books and records when DCAA acknowledges that it cannot provide the assistance required because (1) it concerns matters beyond the proper role of DCAA, (2) it would impede the prompt execution of DCAA's primary role of furnishing accounting and financial management advisory services regarding contracts and subcontracts to DoD components, or (3) it would result in undue delays or inefficiencies in the accomplishment of internal audit objectives. Internal auditors are required by DoD audit policy to coordinate all reviews involving contractor records with DCAA and the appropriate contract administration office to avoid duplication of audit work.

f. Supplement 1-4S1 presents illustrative audit situations involving interface between contract and internal audit.

1-404.3 Government Internal Audit Organization Assistance to DCAA

In certain instances, contract audits involve work at a defense installation or remote location where the nature of the work, proximity of an internal audit office, or other factors make it more practical or economical for the contract auditor to obtain assistance from an internal auditor. Such cross-service audit assistance shall be referred to DCAA Headquarters, Attn: PLD, for a determination before the request is issued.

1-404.4 Contacts by Government Internal Audit Organizations

a. Requests from government internal audit organizations are normally coordinated through DCAA Headquarters, PLD, which in turn will notify the affected regional and field offices. Regional and field offices may receive requests for audit assistance directly from the internal audit organization without prior Headquarters coordination. When such re-

quests are limited in nature, e.g., factual information at a specific location, Headquarters need not be notified. However, all other requests should be referred to Headquarters, PLD, before any action is taken.

b. During the course of visits by a government internal audit organization, such as oversight reviews by the DoD IG, the FAO manager should answer questions raised and tactfully clarify or correct any misinterpretation of factual information. Providing concurrent feedback during the onsite visit should improve the reporting of factual information in the government internal audit organization's written observations and comments. If possible, the FAO manager should request that the representative's written observations and comments be transferred to an electronic file. This will help speed the FAO manager's reporting of the results to the region and Headquarters. Discussions with representatives of the government internal audit organization should be limited to factual matters related to specific DCAA audits and/or the management of those audits. Matters regarding overall Agency policy, operations, or resources should be referred to Headquarters, Attention: PLD. Regional audit manager's attendance is recommended at both the entrance and the exit conferences.

c. The FAO manager should promptly report to the regional office the results of any government internal audit organization's visit. After regional review, the report should be forwarded to Headquarters DCAA, Attention: PLD. Headquarters will forward any necessary reports to the government internal audit organization. FAO reports should be received by Headquarters within ten working days after the visit.

(1) The report should identify the organization's project assignment number and contain all pertinent information, including the purpose of the visit, the government internal audit organization's observations, DCAA responses to specific comments or observations, references to or actual copies of data provided, the representative's reaction after discussions were completed, and any additional comments regarding the representative's reac-

tion. The report should also identify any actions that will be taken as a result of the specific findings of the government internal auditor. The internal auditor's comments or observations will be assumed by Headquarters to be accurate unless disputed in the FAO/regional response.

(2) To simplify field office responses to specific comments or observations furnished by government internal audit organizations, such as in DoD IG oversight reviews, the FAO response may either be provided in a separate document or integrated into the internal auditor's text, if an electronic copy has been supplied. If provided separately, the comments should be keyed to the page number or other identifier in the internal auditor's text. If integrated into the internal auditor's text, preface the FAO/regional comments with the heading "DCAA RESPONSE" for each item addressed.

1-404.5 Issuance of Audit Reports

When an audit performed at the request of an internal audit organization requires corrective action by the contractor involving such matters as unallowable costs and cost avoidance, the auditor will follow the normal practice and issue the audit report to the cognizant ACO to assure timely corrective action. A copy of the report will also be forwarded to the requesting internal audit organization by a transmittal letter indicating that the audit report has been issued directly to the ACO. When an audit performed at the request of an internal audit organization does not require corrective action by the contractor, the audit report will be issued to the internal audit organization (see 10-208).

1-405 Relationship with Military Inspectors General

When an Inspector General of a DoD component, or an IG representative, visits an audit office, the auditor should, after satisfying himself/herself as to the identity of the individual, cooperate fully in responding to inquiries pertaining to the audit of contracts under the auditor's cognizance. Requests for sensitive information, or requests which require the assignment of an auditor for a substantial

period of time, should be in writing. The auditor should report such visits to the regional office and furnish copies of an exchange of correspondence and memorandums. Before furnishing any sensitive information, the auditor should coordinate the matter with the regional director. Unusual or significant inquiries should be reported to Headquarters, Attention: PLD.

1-406 Relationship With Investigative Agencies of the Government

a. Auditors will cooperate with representatives of the Federal Bureau of Investigation, DoD criminal investigators, and criminal investigators from other agencies. (See 4-702.6 and DCAA Regulation 7640.15.) Written material and access to files or working papers will be made readily available to such investigators. The contractor need not be informed when such information is provided to investigators. Original documents may be provided to investigators if a subpoena is issued for the documents. If investigators insist upon obtaining original documents in other situations, promptly refer the matter to Headquarters, Attention: OPD. In either case, original documents cannot be released until copies have been prepared for retention by DCAA. Document all meetings with members of governmental investigative agencies in the audit working papers or the DCAA Form 2000.0 files as appropriate in the circumstances. Guidance pertaining to the protection of information related to investigations is provided in 4-702.5d., e., f., and g.

b. Except as otherwise provided in this section (1-400 et seq.), inform Headquarters, Attention: OPD, of any requests for written material or access to files and working papers made by representatives of other agencies (e.g., civil investigators from the DOL, EEOC, etc.). Ask that the request be put in writing, and that it include the names of the investigators, a summary of the information requested, and purpose of release. Obtain the approval of Headquarters before complying with such requests. The FAO manager

may grant representatives of a civilian agency access to audit files pertaining to that agency's contracts regardless of whether the request is made in conjunction with an investigation; however, Headquarters should be notified of the visit. If the request arises under a joint investigation with an agency with access rights and the request is made by the privileged agency, Headquarters need not be notified.

c. Occasionally an investigator will interview an auditor in connection with an inquiry of contractor activities. The auditor should request to review the investigator's write-up of the interview before its release, to ensure statements have been accurately recorded. Report investigative interviews of an unusual or important nature to Headquarters, Attention: OPD. Identify the investigative agency, name of investigator(s), summary of the questions asked, and other pertinent information. It is not necessary to report routine investigative contacts by DoD investigators.

1-407 Relationship with Government Legal Counsel in Contract Disputes and Bid Protest Cases

It is Agency policy to assist government counsel in auditing matters in all contract disputes and bid protest cases, whether initiated through an Agency finding or by other means when requested to do so by counsel. Audit support should fully respond to the needs of counsel and may consist of comprehensive audit and accounting advisory services; accounting research applicable to the specific case, including testimony relative to the audit report; or testimony as an expert on accounting and auditing practices and procedures. All work done at the request of the government trial attorney is subject to the attorney work product privilege. As such, while DCAA may maintain custody of any documents developed while providing support to the trial attorney, control over the documents rests with the trial attorney or his/her successor. This policy is in keeping with the Agency's assigned responsibility to provide accounting and financial

advisory services to all DoD procurement and contract administration activities in negotiating, administering, and settling contracts.

1-407.1 Armed Services Board of Contract Appeals (ASBCA)

a. Details of the ASBCA Charter are found in Appendix A to the DoD FAR Supplement. The ASBCA is the authorized representative of the Secretaries of Defense, Army, Navy, and Air Force in hearing, considering, and determining appeals by contractors from decisions of contracting officers or their authorized representatives or other authorities on disputed questions. These appeals may be taken pursuant to:

(1) the Contract Disputes Act of 1978,
(2) the provision of contracts requiring the decision by the Secretary of Defense or by a Secretary of a Military Department or their duly authorized representative or board, or

(3) the provisions of any directive whereby the Secretary of Defense or the Secretary of a Military Department has granted a right of appeal not contained in the contract on any matter consistent with the contract appeals procedure.

b. Rules on submitting contractor appeals and preparing for and conducting a hearing are in Part 2 of Appendix A to the DoD FAR Supplement. These rules may vary from a case requiring the submission of a substantial amount of evidence, the presentation of witnesses, and a prehearing and formal hearing to a situation in which the hearing is waived and the case settled on the basis of the submitted record. The rules also provide for decisions of appeals involving \$10,000 or less, under an optional small claims (expedited) procedure or for appeals where the amount in dispute is \$50,000 or less, under an optional accelerated procedure.

c. The auditor will be mainly concerned with ASBCA procedures which require the contracting officer and government trial attorney to submit a file of applicable documents and to produce documents, admit facts, and answer questions when properly requested by the other party to do so. Further details on audit procedures and responsibilities in

connection with ASBCA cases are in 15-500 and DCAAP 7641.50.

1-407.2 Other Boards

In addition to the ASBCA, there are boards that service various other agencies and departments of the government. On occasion, the DCAA auditor may be called on to assist in hearings before these boards. While the size of the board and the rules may vary, the type and degree of services an auditor must provide will generally be the same.

1-408 Relationships with the Internal Revenue Service (IRS)

Procurement-related requests from the IRS (Department of the Treasury) should be handled in accordance with 1-303, following 15-1S7 for distribution of any resulting report. The procedures contained in 1-404 should be followed regarding contacts by the IRS internal audit staff. In addition, field audit offices may receive direct requests from the IRS for records and files related to an IRS investigation or tax matters. The field audit office should coordinate IRS requests for investigative or tax information with the regional office, before providing any information of this type to the IRS. With regional approval, information related to an IRS fraud or criminal investigation, or in connection with a docketed case before the U.S. Tax Court, should be released directly to the IRS. The field audit office should request the IRS to provide information showing that the requested information relates to these situations. For requests related to civil investigation or administrative inquiry, the field audit office is only authorized to release information that would normally be releasable to the general public under the Freedom of Information Act (for example, publications and most MRDs). If the requested documents would not normally be releasable by DCAA to the general public (for example, audit reports or contractor proprietary information), the region should forward the request to Headquarters, Attn: OPD, for a release determination. The region should provide Headquarters with a summary of the information re-

quested, purpose of release, and other pertinent information.

1-409 Relationship with Members of Congress and Congressional Committees

DCAA personnel will cooperate with members of Congress and congressional committees by responding fully and promptly to their official requests for information on this Agency's programs and operations. All written responses and/or copies of DCAA documents will be provided directly by the appropriate Headquarters element. Detailed guidance relative to (1) inquiries from members of Congress, (2) visits by congressional committees, (3) preparation of material for testimony or use before congressional committees, and (4) comments on legislation and legislative matters is set forth in DCAA Regulations Nos. 5020.3, and 5030.16.

The Headquarters Policy Liaison Division (PLD) should be notified immediately of any inquiry from members of Congress, congressional committees, or their staffs.

1-409.1 Written Requests for Information

a. Written requests for information received from Congressional members or their staffs should be forwarded to Headquarters, ATTN: PLD, as expeditiously as possible. When requested by Headquarters, field and regional elements will provide, through the regional director, the following information to the responsible staff element not later than the date established by the head of the staff element: (1) the congressional inquiry, (2) a copy of any interim acknowledgment, (3) a copy of the requested audit report(s), if applicable, (4) a proposed final reply to the inquiry, and (5) the information upon which the proposed final reply is based.

b. When a proposed final reply cannot be forwarded to the responsible staff element within the established due date,

the regional director will forward a brief memorandum stating the anticipated date that the reply and information will be provided. (See DCAAR No. 5030.16 for detailed processing requirements.)

1-409.2 Meetings with and Visits by Congressional Committees

a. Field and regional elements will immediately notify Headquarters, PLD (through the regional director) of written or verbal requests received from Congressional committees or their staff to visit a DCAA office.

b. In accordance with DCAAR No. 5030.16, regional and field personnel will permit committee members or their staff to examine records which pertain to areas of interest to the committee. Regional directors will refer any committee requests to remove or retain records (including audit reports and working papers) to Headquarters, PLD. Headquarters, PLD will coordinate receipt and transmission of requested files to the committee's offices in Washington, D.C. Requests for any other information to be provided to committee representatives will be forwarded to Headquarters, PLD, within 10 working days following the visit. In any case, no information should be released until authorized by PLD.

c. Field and regional elements will forward a memorandum (through the regional director) summarizing visits by Congressional representatives within five working days following the visit. The memorandum should specifically enumerate the subjects discussed during the visit, any requests for data, and questions and answers still to be provided. If a request has been made for audit reports or working papers, the memorandum should also include an assessment of the requested materials' compliance with Agency policy. If the assessment discloses any deficiencies in the reports or working papers, additional comments should be included to clearly establish the steps taken to correct the deficiency.

**1-4S1 Supplement — Illustrative Audit Situations Involving
Interface Between Contract and Internal Audit****1. Audit of Japanese master labor contract.**

The Defense Contract Audit Agency has responsibility for audit of contractual payments. Many of the functions relating to the contract such as the need for, utilization, classification, and control of contract employees; establishing pay and allowances in conformance with the terms of the contract; and submission of payroll data are the responsibility of Army, Navy, and Air Force activities. Internal audit normally would encompass evaluation of these functions. Contract auditors may need internal audit assistance in confirming the accuracy and reliability of reports from military activities which form the basis of contract reimbursements.

2. Audit of small cost-type contracts at remote defense installations.

Travel and per-diem costs may be saved by DCAA obtaining internal audit assistance on audit of relatively small contracts performed at remote defense installations where internal auditors are in residence or in the vicinity. Factors to consider are the location, complexity of the contract audit work, and the availability of internal auditors. An example is a small construction contract at Goose Air Base in Labrador. Audit by DCAA would require travel from New York. Audit can be performed by internal auditors in residence.

3. Audit of administration of government property furnished to contractors.

Prime responsibility for audit of the administration of government property, including that furnished to contractors, is a part of the internal audit mission. However, DCAA likewise performs property auditing in its role of advisor to the property administrator and contracting office, as well as in connection with cost determination. When an internal audit of the government property administration function requires verification of detailed records maintained by a contractor, assistance ordinarily can be obtained from the

cognizant contract auditor. However, if necessary to performance of the internal audit mission, internal auditors will be afforded access to contractor-maintained records.

4. Audit at government-owned, contractor-operated plants.

At GOCO plants DCAA is responsible for audit of the cost-reimbursement operating contracts. Internal auditors are responsible for auditing operations of the Contracting Officer. DCAA should assist the internal auditors by providing such cost and financial information from contractor records as is essential to permit evaluation of the management of the facility.

5. Audit at military installations where services and/or maintenance are purchased under contracts subject to DCAA audit.

Circumstances may be such that the internal auditors need fact-finding assistance from contract auditors to obtain or verify information from contractors' records. For example, the internal auditor may be reviewing the potential for savings from elimination of duplicating supply operations and information is needed from the contract auditor regarding the contractor's supply system.

6. Audit of a weapon system where supply, maintenance, funding, and other functions are closely integrated with input from or operations of major contractors.

Internal audits of this nature give rise to various situations where audit information is needed from contractors' books and records. Assistance from contract auditors would be appropriate in some cases and not in others. Examples follow:

a. Internal auditors are reviewing a contract pricing action. Contract audit assistance ordinarily should not be requested since the contract auditor participated in the procurement team effort.

b. Internal auditors determine that substantial quantities of end items which

have been inspected and accepted are found subsequently to have defects requiring major modification. In trying to ascertain the cause for this situation, the auditors find it necessary to determine whether the contractor has responded timely to contract change orders requiring modification during production. Contract audit assistance in conjunction with technical assistance would be appropriate as determinations of this nature are an integral part of operations audits of contractors' production scheduling and control systems. These determinations are also made during reviews of contractors' internal planning and con-

trol systems when performing Cost/Schedule Control Systems Criteria demonstration/validation reviews.

c. An internal auditor is reviewing the computation of requirements which involve data on assets in the hands of the contractor and reports thereon. Contract audit assistance would be appropriate to verify data furnished by the contractor.

d. An internal auditor is reviewing funding status and validity of obligations which involve data and reports from contractors. Contract audit assistance would be appropriate to verify data furnished by contractors.

1-500 Section 5 — Relationships with Contractors**1-501 Introduction**

Requirements for specific audit conferences with contractors are stated in 4-300. This section covers other aspects of the relationships between DCAA and contractors.

1-502 Establishment of DCAA Field Audit Offices (FAOs) and Suboffices**1-502.1 General**

DCAA Regulation 5005.1 contains the procedures for activation and deactivation of DCAA FAOs. The activation or deactivation of DCAA FAOs (excluding suboffices) is subject to approval by the Director, DCAA, upon the recommendation of the cognizant regional director. The regional director may establish or discontinue suboffices. Regional directors should periodically review the operations of existing FAOs to determine if they still meet the criteria referred to in the regulation or whether, due to changed conditions, any of these offices should be discontinued. Conversely, consideration should be given to establishing FAOs at those locations where the workload so warrants. If any such changes are indicated, submit recommendations to Headquarters, Attn: OWD (with concurrent copy direct to CP), containing the information required by the regulation.

1-502.2 Establishment of Branch Offices

a. A branch office is defined as a DCAA field audit office which (1) performs mobile audit work at all contractors within its designated geographic areas which are not audited by a DCAA resident office and/or (2) performs resident audits of several unrelated contractors through suboffices. Branch offices are established at appropriate locations within DCAA regions for these purposes.

b. A branch office may be located in a contractor facility only if there is unrestricted access to the DCAA office by other (nonhost) contractor representatives and adequate security is provided for data of such other contractors. Regional directors are responsible for estab-

lishing the most efficient and economical arrangements for specific locations within these restrictions. If a branch office is located in a contractor facility, the name of the branch office will not include the contractor's name, and the mail system will be arranged so that DCAA mail does not go to or through the host contractor's system.

c. A branch office may have one or more suboffices. A suboffice is defined as a subordinate element of an FAO. A suboffice may be established (1) at a geographic point distant from the main branch office location if a concentrated workload of mobile audits exists in the area which can be performed more economically by stationing one or a few auditors permanently at that distant point, (2) at a particular contractor location which has a continuous workload requiring the full-time assignment of a few auditors, or (3) at a location where a significant combination of the two preceding conditions exists. A suboffice with both mobile and resident workload must meet the criteria of b above, unless the exception in 1-502.3b applies.

1-502.3 Establishment of Resident Offices

a. A resident office is defined as a DCAA field audit office located at a contractor's facility for the purpose of performing the contract audit workload at the contractor. The office may be made up of suboffices located at components of the same company and still meet the resident office definition.

b. On a case-by-case basis with prior Headquarters approval, limited amounts of mobile work may be assigned to resident offices without changing the office designation. This exception applies only to situations where it is uneconomical or impractical to assign the mobile work to a branch office.

c. Resident offices are usually established at principal locations of major defense contractors. The main criteria for establishing a resident office are whether the audit workload at the contractor is of a continuing nature and is sufficient in

significance, complexity, and volume to warrant a full-time staff large enough to require a resident audit manager and clerical staff.

d. A resident office has the important advantage of enabling auditors assigned to the contractor location on a continuing basis to develop a comprehensive understanding of the contractor's operations and basic management policies and practices in relation to government contracting. This understanding enables more efficient audits of major contractors and more timely and effective audit advice on these contractors to procurement and contract administration activities.

1-502.4 Change of FAO Cognizance

a. Occasionally, FAO cognizance of a contractor organization will change because of such contractor actions as relocations, reorganizations, or consolidations. FAO cognizance of a contractor may also need to be reassigned as a result of DCAA's actions such as establishing new FAOs, consolidating FAOs, or deactivating FAOs. When audit responsibilities of a contractor need to be transferred, the branch or resident office having audit cognizance prior to the change is required to coordinate with the gaining office to assure that continuity of audit services is maintained.

b. Actions to be taken by the losing FAO include:

(1) Issue notification to the major procurement and contract administration activities that do business with the contractor; providing the name, address, and telephone and facsimile numbers of the FAO gaining cognizance of the contractor.

(2) Provide the gaining FAO with a listing of all auditable contracts. The listing should include the name of the procurement office, contract number, type, amount of award, cognizant ACO and identify those contracts that provide for DCAA provisional approval of public vouchers.

(3) Transfer permanent files information, with a transmittal memorandum that lists the content of the files. A copy of the transmittal memorandum should be sent separate of the files and retained

in the permanent files of both the gaining and losing FAO.

(4) Provide a copy of all requirements and program plan data relating to the contractor for the current and prior years.

(5) Prepare a summary of all unresolved issues and forward it, through the new RAM, to the gaining FAO. This summary should include the current status of these issues. Wherever possible, resolution of the issues should be accomplished prior to transferring cognizance to the gaining FAO.

(6) Notify the CAC/GAC of the change in audit cognizance and provide information concerning status of audit issues affecting the CAC/GAC network.

(7) Provide a listing of files maintained at the Federal Records Center to the gaining FAO.

(8) Issue a change of address notification to the Federal Records Center for any audit files that are in records retention. The change of address should be forwarded through the regional resources office, Attn: Records Management Officer (See DCAAM 5015.1).

(9) Provide the regional resources manager, with a concurrent copy to Headquarters, Attn: CP and OWD, a brief explanation of all contractor data maintained in the FMIS that will need to be transferred to the gaining FAO and the effective date of the transfer. When possible, provide this information at least 60 days in advance of the anticipated change.

(10) Transfer any data relating to the contractor that is included in regional or headquarters periodic reports to the gaining FAO, complete with any computer-based files (e.g., incurred cost status report database). Concurrent notification of the change in FAO cognizance should be made to the responsible regional office element.

1-503 Notification of Visits to Contractor Facilities

1-503.1 Security Requirements and Procedures

a. Section 3-101d of the DoD Industrial Security Regulation (DoD 5220.22R) and paragraph 37 of the DoD Industrial

Security Manual for Safeguarding Classified Information (DoD 5220.22M) require that the contractor be given advance notice in writing when access to classified information held by the contractor is involved. The manual requires such notification to include:

The name and title of person(s) to be visited.

The name, title, date and place of birth, citizenship, and security clearance status of the DCAA representative(s).

The purpose of and justification for the visit, including identification of related program(s) or contract(s) and classified information to which access is required, if known.

The date of the proposed visit or period during which the notice is to be valid.

It is DCAA policy to also include the following information:

DCAA identification number (auditor credential card number or equivalent).

Visitor Category (the Industrial Security Manual designates category 1 for U.S. government employees).

b. When a visit will require access to classified matter held by the contractor and/or access to a secured contractor plant, DCAA Form 5220-1 will be used to notify contractors of planned visits. This form will also be used for DCAA personnel permanently located at contractor facilities (such as those assigned to resident offices and suboffices) and for those visiting contractors on a regular basis (such as regional audit managers and members of regional audit teams). Notification in these cases will normally consist of blanket notices submitted on an annual basis. A copy of each notification sent to the contractor will be forwarded to the cognizant contract administration office.

c. DCAA personnel will inform their security officer of planned visits to contractor facilities in sufficient time to enable timely notification.

1-503.2 Required Notice to Contract Administration Offices and Courtesy Notice to Contractors

a. Whether or not access to classified matter or secured area(s) is required, to preclude duplicate demands on the con-

tractor, prospective visitors to contractor facilities are to provide information concerning the visit to the cognizant Contract Administration Office (CAO) sufficiently in advance and in adequate detail so as to permit the CAO to advise the visitors in the event information related to the contract administration functions currently exists that may satisfy the stated purpose of the visit (FAR 42.101(a) and 42.402(a) and (b)). The visitor will make a courtesy telephone call to inform the contractor and make appropriate arrangements if a planned visit will involve contractor personnel. If desired, the visitor may send a letter to confirm arrangements made. Such a letter will not substitute for any notification required by 1-503.1.

b. If a planned visit will involve contract administration personnel, make advance arrangements comparable to those for contractors as stated in a above.

1-504 Access to Contractor Records

1-504.1 General

a. Statutes, implementing regulations, or contract terms may provide access to contractors' records for purpose of audit (1-504.2). The clause at FAR 52.215-2 provides the auditor's primary authority for access to contractor records. This clause must be inserted in all negotiated contracts, except contracts for small purchases (See FAR 15.106-2). This clause provides the contracting officer's representative with the authority to examine and audit contractors' books, records, documents and other evidence and accounting procedures and practices, regardless of form (e.g., machine readable media such as disk, tape, etc.) or type (e.g., data bases, application software, data base management software, utilities, etc.), sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred in performing cost-reimbursement, incentive, time-and-material, labor-hour, or price-redeterminable contracts. The clause also provides access rights for the purpose of evaluating the accuracy, completeness, and currency of cost or pricing data.

¶1-504.1b.

b. In addition to access to specific cost records, access to records refers to contractor policies, procedures, systems, management reports, personnel, minutes of its board of directors meetings, charter and bylaws, and any other information source which affects and reflects the incurrence, control, and allocation of costs to contracts.

c. Adequate audits are possible only when all existing evidence which pertains to the representations, claims, or proposals under audit is available to the auditor. A contractor's failure to make all pertinent records available to the auditor when needed leads to audit reports that contain qualified or adverse opinions, and may result in more difficult negotiations and delay in the contract award or settlement.

d. For field pricing support audits, FAR 15.805-5(e) states that the auditor is responsible for determining the scope and depth of audit. Inherent in this responsibility is the right of auditors to determine the specific records or other evidential matter needed to accomplish the audit. DCAA auditors must adhere to generally accepted government auditing standards in determining what comprises competent, relevant, and sufficient evidential matter. Therefore, auditors must use good judgment and rationale in deciding what contractor records or other evidential matter should be sought. In determining the sufficiency of evidence needed, auditors must consider the audit objective, the risk, and materiality of an error or misstatement in the area being audited and the effect on the audit opinion. See 5-505 for additional guidance on access to contractor budgets and 14-304 on access to cash flow forecasts.

e. FAOs should not enter into written agreements with contractors, or concur with contractor letters, containing access to records provisions or procedures. Any such written agreements may give the appearance of limiting access. However, responses to contractor requests for written confirmation that proprietary data will be protected in accordance with applicable laws and regulations are permissible. See 1-805 for guidance on memorandum of agreements pertaining to

matters other than access to contractor records.

f. While FAOs will not sign agreements, letters or procedures indicating concurrence on access to records matters, they will obtain and review any such documents containing contractor procedures or policies. If the FAO believes the policies and procedures will invoke unreasonable delays, waste audit time or otherwise impede the orderly process of the audit, the contractor should be notified in writing of such concerns in accordance with procedures in 1-504.4, and 1-504.5. If no such concerns exist, the FAO should follow contractor procedural arrangements for obtaining access to needed information.

g. Agreements between a contracting officer and a contractor which appear to restrict DCAA's access to a contractor's records should be transmitted through Headquarters, Operations to the General Counsel for a legal analysis.

1-504.2 Statutory and Regulatory Requirements

Among statutory bases for access to contractor records are 10 U.S.C. 2313(a), "Examination of Books and Records of Contractor," 10 U.S.C. 2306a, ("Truth in Negotiations"), and 41 U.S.C. 422k (Cost Accounting Standards). The following acquisition regulations have implemented these statutory and other access requirements:

a. FAR 15.106-2 requires an "Audit - Negotiation" clause (FAR 52.215-2) in all negotiated contracts other than those which are not expected to exceed \$25,000.

b. FAR 15.804-6 Table 15-2, Instructions for Submission of a Contract Pricing Proposal.

c. FAR 52.215-32 (Certification of Commercial Pricing), implementing 10 U.S.C. 2323(d).

d. FAR 52.230-2 and 52.230-3 (Cost Accounting Standards).

e. FAR 52.216-4 (Economic Price Adjustment - Labor and Material).

f. FAR 52.232-16 (Progress Payments).

1-504.3 Guidance for Requesting Access to Records

a. Records should first be verbally requested during the FAO's normal

course of business with the contractor. The auditor should be ready to discuss the basis for the request with the contractor. CAM or other Agency guidelines should not be cited as the reason for requesting a record in lieu of explaining the underlying audit need.

b. Occasionally contractors may ask that requests for records be in writing. Auditors should generally accommodate the contractor where it will facilitate access and avoid misunderstanding. However, contractor requirements that all requests for records be in writing are unacceptable as such a process would unnecessarily impede the audit process.

c. All requests should be for specific records rather than a general class of records. For example, requests should be for "the general ledger for FY 1985," or "the payroll register for the pay period ending 4 July 1987" rather than "the general ledger," or "payroll data." Addressing specific records relates the request to a specific audit. This action should avoid lengthy discussion with the contractor on the merits of the request.

d. When the auditor does not know precisely what records exist, a listing of what does exist (such as "recurring financial reports" or "EDP files") should be requested. The listing itself may be considered a record, particularly if the contractor already produces such a list for other purposes.

e. Unusual or extensive requests for reproduction of contractor records should be made by supervisors and be in writing if requested by the contractor.

f. When original records or documents are provided by the contractor, auditors will ensure that all such records and documents are returned to the contractor as soon as possible. Due professional care will be exercised in protecting contractor records at all times they are in the auditor's possession. See 1-506 guidelines for safeguarding contractor information.

1-504.4 Conditions Representing Denial of Access to Contractor Records

The following conditions qualify as access to records problems where a specific record is needed within these general areas:

a. Contractor refusal to provide access to any requested record including support for unclaimed costs excluded under CAS 405.

b. Unreasonable delays by contractor representatives in permitting the audit commencement or in providing access to needed data or personnel. Since the determination of unreasonable delay is subjective, it is important to distinguish between occasional delays due to unexpected circumstances (for example, a key employee is out sick) and recurring delays which suggest that it is a contractor's practice to engage in delaying tactics. Recurring delays should be carefully documented with the names of contractor employees, data requested, dates when requested, dates when provided, etc.

c. Restrictions on reproduction of necessary supporting evidential matter.

d. Partial or complete denial of access to internal audit data or other management reports on contractor operations.

e. Denial of access to the contractor's data base. This denial can be a refusal to produce the necessary reports, or allow DCAA to validate reports by testing the database using DATATRAK, or other data retrieval software.

f. Chronic failure of contractor personnel to comply with agreed-to dates for furnishing data.

g. Assertion of attorney-client privilege or attorney work product rule. The auditor is not in a position to accept a claim of attorney-client privilege or the work product rule. Therefore, auditors should request that Headquarters, Operations obtain a legal opinion from DCAA counsel when a claim of privilege is made.

1-504.5 Resolution of Contractor Denials

a. When contractor personnel deny or unreasonably delay access to records needed for audit, auditors should immediately notify and thoroughly discuss the issue with responsible contractor officials authorized to make decisions. Reasonable effort should be made to resolve the issue in a timely manner at the lowest possible DCAA and contractor management level. If access is denied following the initial conference with the contractor, the auditor should follow the procedures cited in DCAA Instruction No. 7640.17.

11-504.5b.

b. When implementation of DCAA Instruction No 7640.17 does not resolve contractor denial of access to records, then the regional office should consider requesting Headquarters to subpoena the records in accordance with DCAA Regulation No. 5500.5. The DCAA Director is authorized to subpoena contractor documents and records needed to audit costs incurred under flexibly priced government contracts and subcontracts, and to audit the accuracy, completeness, and currency of cost or pricing data used for negotiated government contracts and subcontracts.

1-504.6 Impact of Contractor Denial of Access to Records

a. Costs which are unsupported due to lack of access to records should be questioned under price proposals. Such costs should also be questioned on progress payments and suspended under cost-reimbursement contracts per 6-902a. A contractor's denial of access to records may be so extensive that it is impractical to perform any audit or determine an amount affected by the denial. In such a case, immediately notify all procurement and contract administration activities that may be involved with the subject audit and request their assistance. In addition, the auditor should recommend suspension of payments on all affected contracts until the access to records problem is resolved.

b. The impact of a contractor's denial of access to records on the scope of audit should be described in the "purpose and scope of audit," "circumstances affecting the audit," and, "summary of audit results," paragraphs of the audit report. The report should identify the records that were sought, discuss the need for the records, and describe the measures that were taken to gain access (see 10-209.2).

1-505 Records Destroyed or Not in Condition for Audit

a. When the contractor's records are inadequate, not current, or otherwise not in condition for audit, immediately bring the deficiency to the contractor's attention. If corrective action is not instituted promptly, notify the regional office, the

requesting procurement activity, and other government offices affected. The auditor should not undertake or participate in correcting the deficiencies.

b. When records are alleged to have been destroyed, lost, stolen, or otherwise cannot be located, obtain a written statement from the contractor describing the circumstances. Notify the contracting officer of the extent to which an audit can be made using the remaining available records. The auditor should not attempt reconstruction of contractor's records.

c. Any audit reports issued under these circumstances should contain appropriate comments on all the facts, with any necessary disclaimer, adverse opinion, qualifications, and/or explanations of questioned costs.

1-506 Safeguarding Contractor Information

a. Perform audits in such privacy as warranted under the circumstances, and provide all necessary safeguards of contractor-confidential data. Working papers, audit reports, unpublished financial statements, correspondence, files, and other records and sources available to or in the possession of the auditor usually contain information which the contractor regards as confidential. Use such information only for performance of official duties. The auditor shall not disclose the information to other persons except with the contractor's permission, and shall not discuss information in a manner which might permit disclosure to unauthorized persons.

b. The law pertaining to unauthorized disclosure of contractor information, and penalties for violation thereof, is contained in 18 U.S.C. 1905, as amended, and is quoted below:

Whoever, being an officer or employee of the United States or of any department or agency thereof, or agent of the Department of Justice as defined in the Antitrust Civil Process Act (15 U.S.C. 1311-1314), publishes, divulges, discloses, or makes known in any manner or to any extent not authorized by law any information coming to him in the

course of his employment or official duties or by reason of any examination or investigation made by, or return, report or record made to or filed with, such department or agency or officer or employee thereof, which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation, or association; or permits any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; shall be fined not more than \$1,000, or imprisoned not more than one year, or both; and shall be removed from office or employment.

c. Release of contractor information to the General Accounting Office, members of Congress and congressional committees and their staffs, offices of inspector general, and government investigative agencies should be handled in accordance with the procedures outlined in the applicable paragraph under 1-202, 1-405, or 1-406. Release of contractor provided information in litigation is governed by DCAAR 5410.11 and the discovery rules of the forum involved. Release of contractor provided information in response to requests under the Freedom of Infor-

mation Act is governed by DCAAR 5410.5.

1-507 Assistance in Preparing Claims Against the Government

a. Officers and employees of the government are prohibited by law (18 U.S.C. 205) from acting as agents or attorneys for prosecuting any claim against the United States or aiding or assisting in the prosecution or support of any such claim other than in the proper discharge of their official duties. A part of the auditor's official duties is to inform contractors of the manner in which public vouchers, termination settlement proposals, cost statements, and other financial representations connected with the negotiation and performance of government contracts should be prepared and submitted.

b. The auditor may advise contractors as to types of costs which are considered allowable and unallowable and on request may orally express an opinion as to the acceptability of a specific item of cost.

c. Advise contractors to screen and not claim costs specifically unallowable by contract terms, statute, public policy, or government regulations. If the contractor consistently claims costs which are clearly unallowable under the contract terms, refer the matter to the Plant Representative/ACO for appropriate action. (See 8-405.)

1-600 Section 6 — Relationships with the News Media

1-601 Introduction

This section contains guidelines regarding contacts with the news media.

1-602 General

DCAA Regulation 5230.1 implements DoD Directive 5230.9, Clearance of DoD Information for Public Release. The Regulation includes guidance regarding information to be furnished the news media. Information in any form concerning Agency plans, policies, programs, or operations must be cleared through Headquarters before release.

1-603 Processing Requests for Information

Agency personnel are often contacted directly by the news media. Although talking with the news media is not prohibited, the above references govern the release of information. If contacted by the media, the employee should obtain the person's name, the organization represented and telephone number, and the questions to be answered. This information and the circumstances surrounding the request should be conveyed to the Agency Executive Officer (DX), Headquarters. The Executive Officer is responsible for deciding how the request from the media will be satisfied and for obtaining appropriate clearance for the release of information.

1-700 Section 7 — Processing Freedom of Information Act (FOIA) Requests**1-701 Introduction**

This section contains information and pertinent references for processing Freedom of Information Act (FOIA) requests.

1-702 General

The Freedom of Information Act, 5 U.S.C. 552, is a public law which is designed to allow the general public access to government records. DCAA Regulation 5410.8, DCAA Freedom of Information Act Program, implements DoD Directive 5400.7, DoD Freedom of Information Act Program. DCAA's implementing regulation is codified as 32 C.F.R. Part 290 and contains policy and procedural information relative to the Act. This issuance is supplemented by DCAAP 5410.14, DCAA Freedom of Information Act Processing Guide, and DCAAP 5410.12, FOIA: A Manager's Guide to a Complex Law, and Chapter 19 to DCAAM 5020.9, FAO Administrative Manual. A self-paced tutorial on the FOIA may be found on the local area network as part of the info systems menu.

1-703 Scope of the Statute

All audit work products are subject to public demand under the Freedom of Information Act. Although there is a preference for release of government documents, aspects of these documents may be subject to withholding under one or more of the established exemptions contained in the Act. The Agency must prove that a specific harm will be realized to

preclude release of the requested records. An explanation of the exemptions is contained in DCAAP 5410.14.

Typically, requesters seek copies of audit reports and working papers. Some requests are specific to a particular audit report while others are more general. Since the release of most audit reports is at the sole discretion of the contracting officer, the primary demand for records will be limited to the working papers. Requests for DCAA records compiled to support an ongoing investigation are normally referred to the investigative agency for processing until all actions related to the case have been resolved. Similarly, requests that would cover records generated in support of a trial attorney are covered by the attorney work product privilege. Their release should be coordinated with the trial attorney or his/her successor.

1-704 Processing Requests for Information under the Freedom of Information Act

Request for records may require a search of the Agency's records to identify potentially responsive documents and information pertinent to the releasability of each record. Specific instructions for the processing of each request will be provided by the FOIA Coordinator at the regional level and the DCAA Information and Privacy Advisor for the Headquarters. A listing of Agency FOIA personnel may be found in DCAAR 5410.8 and DCAAP 5410.14.

**1-800 Section 8 — Auditor Participation on Contractor and Government
Process Action Teams (PATs) and Process Oriented Contract
Administration Services (PROCAS)**

1-801 General

a. Auditors are often asked to participate on contractor or government PATs. In most cases, the PATs' objectives are to study and suggest improvements to systems of internal controls as well as to analyze the efficiency and effectiveness of the process. This section provides guidance on auditor participation on PATs.

b. PATs are generally formed to evaluate and improve a process or system. Generally, PAT membership is cross-functional and consists of nonmanagement personnel. PATs are generally advisory in nature and provide their recommendations to management for further consideration and implementation.

1-802 Auditor's Role on Contractor PATs

a. The auditor can be a full voting participant on PATs that are not empowered to make management decisions. Usually, the auditor is asked to participate on PATs addressing contractor systems for which DCAA has audit responsibility such as billing, estimating, compensation, and accounting systems. For PATs focusing on other systems for which DCAA does not have the primary responsibility, DCAA should provide support as requested and appropriate in the circumstances.

b. DCAA's role as independent financial advisor to the contracting officer limits our participation on contractor PATs, steering committees, quality boards, or other similar groups that are empowered to make management decisions. The auditor can participate in most of the team activities such as team meetings, discussion of risk areas, discussion of key internal controls, establishing evaluation criteria, and the development of metrics. However, the auditor cannot be involved in a decision-making process such as voting on implementation of recommendations and corrective actions.

c. Actual and perceived independence must be maintained by not participating or being identified with contractor management groups. Examples of management groups that generally make management decisions include executive steering committees, quality councils, and management advisory boards.

d. The auditor should document important aspects of participating on the PAT. Examples of items to document include coordination of specific risk areas that should be considered by the PAT for improvement, the PAT's objective, the auditor's role on the PAT, identification of key PAT milestones and when these milestones were accomplished, attendance at key PAT meetings, the PAT's recommendations, and metrics used to assess effectiveness of the system. The auditor should also follow up to evaluate any recommendations made to the system and consider these improvements when scoping any future audits of the system.

e. Since the system that is being evaluated by the PAT belongs to the contractor, the contractor performs most of the action to implement improvements to the system, while the government actively monitors the improvements. The auditor's participation on contractor PATs does not preclude DCAA from conducting audits and expressing an opinion of the particular process in the future as are considered necessary, even if the opinion is contrary to the recommendation or conclusions of the PAT. Figure 1-8-1 is an example of a letter that should be sent to the contractor describing the auditor's role on contractor PATs.

1-803 Auditor's Role on Government PATs

Auditors can fully participate on government PATs that are studying processes involving DCAA mission responsibilities. Examples of government PATs that auditors are frequently asked to participate on include PATs formed to

study and suggest improvements on acquisition processes or regulations.

1-804 Process Oriented Contract Administration Services (PROCAS)

a. Process Oriented Contract Administration Services (PROCAS) is a Defense Contract Management Command (DCMC) initiative to foster and promote continuous contractor process improvement through teaming efforts. The fundamental concepts of PROCAS are similar to Total Quality Management and Contractor Risk Assessment Guide (see 3-104.4).

b. When implementing PROCAS, representatives from the contractor, DCMC, the buying office, and DCAA use analytical techniques to evaluate and make continuous improvements to contractor and government processes.

c. The auditor should be asked to participate on PROCAS teams that will be evaluating systems for which DCAA has audit responsibility such as billing, estimating, compensation, and accounting systems. For other systems for which DCAA does not have primary responsibility, the FAO should provide support as requested and as appropriate. The guidance discussed at 1-802 and 1-803 also applies to DCAA's participation on PROCAS teams.

d. The auditor should be involved in the system selection process to ensure that high-risk systems identified by DCAA are considered for selection by the PROCAS team. This is accomplished by coordinating audit plans with the PROCAS team, sharing risk assessments, and recommending that the PROCAS team select systems identified with high risk to the government. This will assist the PROCAS team to identify, prioritize, and select high-risk systems for review.

1-805 Memorandum of Agreement

Sometimes when participating on PATs, PROCAS teams, or other similar types of teams, the auditor may be asked to sign a teaming agreement or memorandum of agreement (see 1-504.1.e for guidance on memorandums of agreement pertaining to access to contractor records). Auditors generally should not sign these agreements. The auditing standard of independence precludes DCAA from entering into most agreements. If the contractor or Federal agency insists on the FAO entering into such agreements, the FAO should send the proposed memorandum of agreement and background material before executing the agreement through the regional office to Headquarters, Attn: PFD, for coordination.

January 1995

Figure 1-8-1
Notification Letter to Contractor

■ Danica Smith, Controller
ABC Corporation
507 Main Street
Any City, State 00000

Dear Ms. Smith:

You have requested that DCAA provide a participant on a PAT you are establishing to study and suggest improvements in your processes and internal controls for [identify system or process that is being evaluated]. I believe your desire to pursue continuous process improvement in this critical area has significant potential benefit to the government. Accordingly, I have assigned _____ Ms./Mr. _____ of my staff to participate. They may be contacted at [telephone no.].

While I am supportive of your PAT efforts and understand the value of a DCAA participant, it is important that you acknowledge the following conditions regarding such participation. Ms./Mr. _____ is participating in her or his individual capacity, and his or her contributions do not represent formal audit opinions of the DCAA. As such, DCAA reserves the right to conduct such audits in the future as are considered necessary, in accordance with FAR, and to render independent opinions as a result of such work, even if such opinions are contrary to the recommendations or conclusions of this PAT.

Sincerely,

James Jones
FAO Manager

January 1995

2(1)

CHAPTER 2

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CHAPTER 2

2-000 AUDITING STANDARDS

2-001 Scope of Chapter

a. The term "audit" is used to refer to a variety of types of examinations and reviews by a person other than the preparer of the data. There is no commonly accepted definition of precisely what constitutes an audit that can be assumed to apply to all cases in which the term is used. In order to be understood, the term "audit" must be accompanied by an explanation of (1) the auditing standards followed and, (2) if not otherwise implied by the standards, the purpose and scope of work undertaken.

b. Auditing standards differ from audit procedures as discussed elsewhere in CAM in that procedures relate to acts to be performed, whereas standards deal

with measures of quality of the performance of those acts and the objectives to be attained by use of the procedures undertaken.

c. Government audit standards include generally accepted auditing standards of the American Institute of Certified Public Accountants and audit policy statements of the General Accounting Office and the Office of Management and Budget. It is important to understand these standards and how they affect DCAA audits. Generally these standards govern (1) the quality of the audit performance, (2) the nature and extent of audit evidence to be obtained by means of auditing procedures, and (3) the nature and content of audit reports.

2-100 Section 1—Generally Accepted Auditing Standards and Their Relationship to DCAA Audits

2-101 AICPA Auditing Standards

a. Generally accepted auditing standards ("GAAS") refer to the auditing standards approved and adopted by the membership of the American Institute of Certified Public Accountants (AICPA). The standards are oriented toward independent audits of financial statements. They also apply, however, at least in part, to audits of "selected financial data" that is less than a complete financial statement and to agreed-upon audit procedures examinations (less than a full-scope audit) that may be used in certain circumstances when a "special" report providing less assurance than an audit in accordance with GAAS is to be issued. Thus, they may be applied to the audit of a contract, a particular transaction, or a department of a business, governmental, or nonprofit entity.

b. The AICPA, through its Auditing Standards Board, has also issued an extensive series of interpretations of its standards (referred to as Statements on Auditing Standards (SAS), which CPAs are expected to follow in order to comply with GAAS. A copy of the AICPA publication with all of the SAS is in each DCAA field audit office library. The AICPA also publishes "audit guides" to provide relatively specific guidance for the audit of companies in certain specialized industries such as banking, investment companies, finance companies, etc. Of special interest to DCAA auditors is the Guide for Audits of Federal Government Contractors, published in 1990. The guide is tailored for an audit pursuant to GAAS of complete financial statements of contractors prepared in accordance with Generally Accepted Accounting Principles (GAAP) and addresses many of the same internal control and compliance issues of concern to DCAA auditors. A copy of the guide is included in each DCAA field audit office library.

2-102 Other AICPA Standards

a. In addition to performing audits of "historical" financial statements in ac-

cordance with GAAS, auditors perform other types of "attest" services to which other AICPA standards apply. For example, separate standards have been issued for "prospective" financial statements which include forecasts and projections. These standards provide for a four-level approach to such data in which the auditor may perform either (1) an "examination" of the data, (2) a "review" of the data, (3) a "compilation" of the data, or (4) agreed-upon procedures which are generally less than (1) and either more or less than (2). The existence of these four levels of work provides the auditor with considerable flexibility to tailor the engagement to the needs of the user of the audit report.

b. Separate standards also have been issued for other types of attestation engagements. Commonly, these engagements involve reports of statistical or factual non-financial statement data, but also may involve such matters as compliance with a prescribed code of ethics, or other prescribed procedures or standards. The attestation standards are a natural extension of the GAAS for financial statement audits. They deal with the need for technical competence, independence in mental attitude, due professional care, adequate planning and supervision, sufficient evidence, and appropriate reporting.

2-103 Government Auditing Standards

a. "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions" are developed and published by the Comptroller General. The latest version was published in 1988. A copy is included in each DCAA field audit office library. The Comptroller General's standards incorporate GAAS by reference and add standards for matters of unique concern in government audits. The Comptroller General's standards identify government contract audits as being "financial related audits" to which certain financial statement audit-

ing (as opposed to compliance or other audits) standards apply. OMB Circular A-73, dated 20 June 1983, and DoD Directive 7600.2, dated 26 January 1990, incorporate the Comptroller General's standards by reference as well as those issued by the President's Council on Integrity and Efficiency and the Inspector General of the Department of Defense. The government auditing standards are applicable to DCAA.

b. The government auditing standards have expanded the AICPA's general auditing standards to require continuing education and a quality control program, and adopted the AICPA auditing standards for audit field work and reporting. Standards related to the following matters have been added for governmental audits:

(1) Planning should include consideration of the audit requirements of all levels of government.

(2) A test should be made of compliance with applicable laws and regulations.

(3) Performance audits will assess the economy and efficiency of operations or programs.

(4) Requirements for working papers set the level of documentation which the auditor must develop.

(5) Supplemental reporting standards deal with reporting on compliance, illegal acts, internal controls, and performance audits.

c. Under GAAS, an auditor is not required to evaluate, per se, the reasonableness of business operating decisions or matters of management and operational efficiency that directly impact operating costs. Government auditing standards for performance audits require the auditor to consider such matters. Performance audits should determine (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently; (2) the causes of inefficiencies or uneconomical practices; and (3) whether the entity has complied with the laws and regulations concerning matters of economy and efficiency. These performance audit standards relate to DCAA operations audits and other such audit activities carried out to assess the reasonableness of contract cost.

2-200 Section 2—General Standards

2-201 Introduction

This section explains the “general standards” element of government auditing standards for conducting audits. General standards relate to the qualifications of the staff, the audit organization’s and the individual auditor’s independence, the exercise of due professional care in performing the audit and in preparing related reports, and the presence of quality controls.

2-202 Qualifications

The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required.

a. This standard requires that those assigned to the job collectively have the skills necessary for the task at hand; their qualifications should be commensurate with the scope and complexities of the assignments. Audits vary in purpose and scope. Some require an opinion on the adequacy of financial representations; others an opinion on compliance with specific laws, contractual provisions, and other requirements; others require reviews of efficiency and economy of operations; and still others require some or all of these elements. Since audits frequently require a wide variety of skills, an auditor may need technical assistance from other disciplines such as legal, engineering, and production/quality control. The auditor should make arrangements to secure any needed technical assistance from the ACO/plant representative or responsible acquisition agency.

b. The effectiveness of contract audits is governed in large measure by the caliber and training of the person or persons performing the work. The auditor is expected to have acquired through continuing education, training and experience the ability to plan; to devise and apply effective audit procedures; to determine facts; to make reasonable judgments and decisions; and to prepare objective and effective reports.

c. The continuing education and training may include such topics as current developments in audit methods, accounting, assessment of internal controls, principles of management and supervision, financial management, statistical sampling, evaluation design, and data analysis. It may also include subjects related to the auditor’s field of work, such as public administration, public policy and structure, industrial engineering, economics, social sciences, and computer science.

d. DCAA requires all audit staff members to complete 80 hours of professional training or development during each two-year reporting period. At least 20 of the 80 hours of training must be completed in each fiscal year. These hours of training shall be referred to as continuing professional education (CPE) credits, and the terms training and education are used interchangeably.

e. Continuing professional education is a shared responsibility of Headquarters and the regions; however, the primary responsibility resides with the individual supervisors and staff members. DCAA staff must have satisfied the CPE requirement to meet the government auditing standards underlying audit planning, directing, conduct, and reporting. The specific responsibilities of all parties are defined in the DCAA Personnel Management Manual, DCAAM 1400.1.

f. These standards do not exclude the use of auditors in a training status, as long as trainees are assigned duties commensurate with their experience and capabilities and are adequately supervised. Proper supervision of the work done by trainees will contribute to their development and skill and should assure maintenance of acceptable standards.

2-203 Independence

In all matters relating to the audit work, the audit organization and the individual auditors should be free from personal or external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance.

a. As an employee of DCAA, the contract auditor's primary responsibility is to protect the interests of the government. However, the auditor's effectiveness depends on the ability to develop and evaluate facts and arrive at sound conclusions objectively (based on unbiased judgments) and independently (not subject to influence or control by others). The matter of independence and objectivity also requires that the auditor not identify so closely with contractor personnel that practices or decisions of the contractor go unexamined or are examined only cursorily.

b. The conduct of audits and preparation of reports may require the display of courage, particularly with respect to audits involving sensitive areas (e.g., matters affecting contractor profits or cash flow). Therefore, the auditor's status and organizational position should provide the authority and opportunity to make and report findings and recommendations objectively.

c. Each auditor has an obligation to refrain from entering into any relationship (financial, social, or other) with contractors and their officers and employees which would impair his or her objectivity or reflect discredibly on him/her or the DoD. It is essential that he or she observe the prescribed Standards of Conduct (DCAA Regulation No. 5500.2) to ensure compliance with the ethical standards demanded of all public servants.

d. It is important not only that the auditor be independent and impartial in fact, but also that other persons consider him or her so. In this connection, there are three general classes of impairments that the auditor should consider: personal, external, and organizational. If one or more of these affect his or her objectivity, he or she should decline to perform the audit. Some brief examples of the three types of impairments follow:

(1) Personal. In some circumstances an auditor cannot be impartial because of his or her views or personal situation. These circumstances could include: relationships of a personal nature that might limit or inhibit his or her inquiry; preconceived ideas; prior employment with the contractor being audited; and financial

interest, direct or indirect, in the entity being audited.

(2) External. These factors can restrict the audit or infringe on the auditor's ability to form independent and objective opinions and conclusions and may include: interference in the scope and character of the audit that could modify audit results; denial of access to sources of information such as books, records, and supporting documents or officials and employees of the organization under audit; interference in the assignment of personnel to the audit task; actions by contractors significantly influencing the auditor's judgment regarding the content of the audit report; and unreasonable restrictions on the time allowed to competently complete the audit assignment.

(3) Organizational. The auditor's independence can be affected by his or her place within the organizational structure of government. To achieve maximum independence, auditors and their respective audit organizations not only should report to the highest echelon within their governmental component but should be organizationally independent. DoDD 5105.36 (see Supplement 1-1S1) established DCAA as an independent agency of DoD; accordingly, an environment exists where DCAA can function in an independent, objective manner in performing its contract audit services.

2-204 Due Professional Care

Due professional care should be used in conducting the audit and in preparing related reports.

a. The matter of due care concerns what the independent auditor does and how well he or she does it. For example, due care in the matter of working papers requires that their content support the auditor's opinion.

b. In the exercise of due professional care, the auditor must be fully aware of the purpose of the review and must be mentally alert, inquisitive, and responsible. Due care also requires all supervisors to look critically at the work done and the judgments made by those assisting in the examination.

c. Due professional care requires that the auditor observe recognized auditing

standards and apply them professionally, not perfunctorily. Application of due care represents the difference between auditing by the continuous exercise of good judgment and mere checking by rote. Professional auditing cannot be reduced to rote; the auditor's judgment is vital at almost every point in the examination. Unusual care in the mechanics of auditing is necessary to ensure competent work because the auditor's opinion is based on personal judgment and on information obtained by tests, sampling, and other appropriate methods.

2-205 Quality Control

Audit organizations conducting government audits should have appropriate internal quality control systems in place and participate in an external quality control review program.

a. A strong internal quality control system has been in place within DCAA since its inception. The system has been well documented in the Agency's charter, regulations, instructions, contract audit manual, personnel management manual, etc. Agency managers and supervisors serve as the focal point for assuring that

policies and procedures are adequate (including appropriate reflection of auditing standards) and are properly applied. The functioning strength of the Agency's system is apparent in the attention given to improving it over the years. In particular, the Agency's implementation of the Federal Financial Managers Financial Integrity Act and related DoD internal management control system requirements (DoD Directive No. 5010.38) was achieved by consolidating the various existing quality controls. Procedures are in place for periodic vulnerability assessments and internal reviews.

b. Organizations conducting government audits should have an external quality control review at least once every three years by an organization not affiliated with the organization being reviewed. The external quality control review program should determine that: (1) the organization's internal quality control system is in place and operating effectively and (2) established policies and procedures and applicable auditing standards are being followed in its audit work. For DCAA this function is performed primarily by the Department of Defense, Office of Inspector General.

**2-300 Section 3 — Field Work Standards
for Financial Statement and Financial Related Audits****2-301 Introduction**

The field work standards explained in this section are to be followed in performing financial statement audits and financial related audits. Financial related audits are defined as including contract audits such as those performed to evaluate bid proposals, contract pricing, amounts billed, amounts due on termination claims, and compliance with contract terms.

2-302 Planning

The auditor's work will be adequately planned. This standard particularly concerns the timeliness of audit procedures and the orderliness of their application. It places upon the auditor the responsibility for scheduling in advance for an effective and timely audit.

a. Before beginning an audit assignment, it is essential to understand fully the purpose of the audit, to be aware of contractual, regulatory, or other factors pertinent to the review; and to consider the type of report to be prepared upon completing the assignment. The initial planning phase includes a review of pertinent files, such as the working papers of previous audits, copies of contracts, and correspondence related to the current audit. It also includes discussion and coordination with procurement officials and contractor personnel, so that the work may proceed smoothly and efficiently. When appropriate, arrangements should be made for audits of costs of subcontractors or other divisions of the contractor and for technical assistance.

b. The auditor should consider whether specialized computer-related skills are needed to help determine the impact of computer processing on the overall audit. For example, the auditor needs to assess if special computer skills are needed to help understand the flow of transactions through the system, to help determine the nature of the accounting control procedures for the system, or to help design and perform the audit procedures neces-

sary to review the system. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be within either DCAA or government procurement organizations. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to (1) communicate the objectives of the other professional's work, (2) evaluate whether the specified procedures will meet the auditor's objectives and (3) evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants functioning as members of the audit team.

c. The auditor should consider the methods the contractor used to process accounting information in planning the audit because such methods influence the design of the accounting system and the nature of the internal accounting control procedures. The extent to which computer processing is used in significant applications, as well as the complexity of that processing, may also influence the nature and extent of audit procedures.

d. Before preparing audit programs, the entity to be audited should be surveyed. A skillfully performed survey should provide information about the size and scope of the contractor's activities and any areas in which there may be weaknesses in internal controls, uneconomical or inefficient operations, ineffectiveness in achieving prescribed goals, or lack of compliance with applicable laws and regulations. Tests to determine the significance of such matters are to be performed in the detailed audit work and should be carefully set out in the audit program. It should be emphasized, however, that the survey discussed here is primarily a review of prior audit work (e.g., permanent files). At major contractors, the main source of internal control information is normally the applicable system review which is summarized on the internal control audit planning sum-

mary sheet in the permanent file (see 3-300 and 5-100). To the extent that this prior audit work does not provide the auditor with adequate planning information, the scope of the audit being planned may have to be expanded.

e. A written audit program should be prepared for each audit to effectively communicate objectives to all staff members, to facilitate control of the audit work, and to provide a permanent record of the work to be accomplished. Where appropriate, the Agency's standard audit program can be used to meet these objectives; or, if necessary, it can be used as a starting point for developing an audit program tailored to the specific review being planned. Although the information needed to prepare a satisfactory audit program will vary with each assignment, it should ordinarily include the following:

(1) The purpose of the audit and its scope.

(2) Information concerning the contractor's operations, its sources of revenue, principal locations, and similar items needed to understand the objectives and operational characteristics of its work.

(3) A carefully drawn statement of what the auditor is expected to produce as a result of the audit. This statement should tell the auditor the issues in which he or she is expected to reach conclusions. In financial and compliance audits, the financial reports to be examined should be specified as well as principal laws and regulations to which compliance is to be determined. In audits of economy and efficiency, the criteria prescribed for evaluating the economy and efficiency of the audit area should be clearly set out.

(4) The procedures to be used. When multilocation programs are to be performed, the audit organization that is centrally planning the work should usually prescribe very specific methods to be followed in the examination to be sure that the data obtained from all participating locations will be comparable. However, this should be done in a manner that does not restrict the auditor's professional judgment. Audit programs should never be used as a blind checklist or in a way that stifles initiative, imagination, and thoroughness in performing an audit.

2-303 Supervision

Assistants are to be properly supervised. This standard places upon the auditor the responsibility for ensuring that subordinate staff members receive appropriate guidance.

a. When assistants are used, the amount of preparatory training and the direct on-the-job supervision required on a given assignment will vary according to the assistants' experience and competence. The auditor-in-charge is responsible for ensuring that assistants are appropriately instructed in the particular segments of work assigned and that their work is professionally competent. Responsibility cannot be severed from authority; the auditor-in-charge as well as other supervisory auditors must exercise due care in supervising assistants and in reviewing their work and judgments.

b. Supervisory review should be directed to both the substance and the method of auditing. The review should ensure that (1) the auditor conforms to the auditing standards, (2) the audit programs are followed, unless deviation is justified and authorized, (3) the working papers adequately support findings and conclusions, (4) the working papers provide adequate data to prepare a meaningful report, and (5) the auditor will accomplish the audit objectives. Documentation of supervisory reviews should be prepared and retained.

2-304 Legal and Regulatory Requirements

In performing contract audits, auditors should be knowledgeable of laws and regulations applicable to the costing and pricing of government contracts. For example, when contracts are subject to specific federal laws and regulations where violation may entail contractual penalties (such as Truth in Negotiation Act (10 U.S.C. 2306a); Cost Accounting Standards (50 U.S.C. App. 2168); or Walsh-Healey Public Contracts Act (41 U.S.C. 35-45)), contracts are required to describe the general provisions of the law and the penalty or penalties for violation.

a. This standard places upon the auditor the responsibility for determining

whether contractors have complied with contractual costing and pricing requirements. As a general rule, audit files should contain details concerning the laws and regulations pertinent to the government contracts under audit. Additionally, liaison between the auditor and the administrative contracting officer should provide the information necessary to keep the files current.

b. The standards for reporting require a statement in the report regarding any significant instances of noncompliance disclosed by the examination and evaluation work. What is to be included in this statement requires judgment. The auditor cannot be expected to be completely knowledgeable about legal ramifications of all noncompliance issues but should seek assistance from DCAA and government procurement legal counsel in instances when specific guidance is not available. Insignificant noncompliances need not be disclosed except where they could result in significant adjustments due to changed circumstances. When a noncompliance is reported, the auditor should place the findings in proper perspective. The extent of instances of noncompliance should be related to the number of cases examined to provide the reader with a basis for judging the prevalence of noncompliance.

c. In determining the nature, timing, and extent of the audit steps and procedures to test for compliance, the auditor should assess the risk of noncompliance with laws and regulations occurring and having a direct and material effect on the results of contract audits. The auditor should assess the risk that the entity did not comply with those laws and regulations and the risk that the entity's control structure to ensure compliance with laws and regulations might not prevent or detect that noncompliance. At major contractor locations this assessment of control risk is normally maintained in the Internal Control Audit Planning Summary sheet maintained in the permanent file.

d. Cost Accounting Standards (50 U.S.C. 2168) are issued to achieve (1) an increased degree of uniformity in cost accounting practices among government contractors in like circumstances, and (2)

consistency in cost accounting practices in like circumstances by individual government contractors over periods of time. Increased uniformity and consistency in accounting improve understanding and communication, reduce the incidence of disputes and disagreements, and facilitate equitable contract settlements. FAR 30.202-6c and 30.202-7b outlines the basic functions of the contract auditor in the implementation of the Cost Accounting Standards. The broad base of CAS coverage on DoD contracts, coupled with the number and scope of the standards promulgated, have had a substantive effect on DCAA audit procedures and responsibilities.

e. In determining compliance with laws and regulations the auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the results of contract audits. The auditor should also be aware of the possibility of illegal acts that could have an indirect and material effect on the results of contract audits.

2-305 Internal Control Structure

a. The auditor should obtain a sufficient understanding of the internal control structure to adequately plan the audit. At major contractors, the review to gain this understanding is normally performed and documented in separate audits of the contractor's systems, and summarized on the internal control audit planning summary (ICAPS) forms (see 3-300 and 5-100). This understanding should include knowledge of the contractor's control environment, accounting system, and relevant control procedures. The auditor should also determine whether relevant policies and procedures have been placed in operation. Generally, relevant policies and procedures pertain to a contractor's ability to record, process, summarize, and report contract and financial information, and to ensure compliance with applicable laws and regulations.

b. Knowledge may be obtained from various sources, including previous audits, inquiries of management officials

and others, and observations of contractor operations. The extent of knowledge required depends upon the auditor's judgements concerning inherent risk, materiality, and the complexity and sophistication of the contractor's operations and systems, including whether the method of controlling accounting data is highly dependent on computerized controls. Additional guidance on the review of contractor internal control structures is contained in Chapter 5.

c. The auditor should document the understanding of the contractor's internal control structure. The form and extent of the documentation is influenced by the size and complexity of the contractor and the contractor's internal control structure. Documentation of the internal control structure of a large complex contractor may include flowcharts, questionnaires, narratives, computer program documentation, etc. For a small contractor, less documentation may be required. Additional guidance on the documentation of contractor internal control structures is contained in 5-100.

d. A contractor's internal control structure is comprised of three elements: the control environment, the accounting system, and the control procedures. Characteristics of a satisfactory internal control structure are discussed in Chapter 5 and other chapters and appendixes of this manual.

2-305.1 Control Environment

a. The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, the functioning of the board of directors and its committees, the methods of assigning authority and responsibility, management's control methods for monitoring and following up on performance, management's attitude toward internal and external audit, the entity's personnel policies and practices, and various other external influences that affect an entity's operations and practices.

b. Obtain sufficient knowledge of the control environment to understand man-

agement's and the board of directors' attitude, awareness, and actions concerning the control environment. Concentrate on the substance of management's policies, procedures, and related actions rather than their form, because management may establish policies and procedures but not act on them. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

c. Additional guidance on the review of contractor policies is contained in Chapter 5.

2-305.2 Accounting System

a. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report accounting transactions and to maintain accountability for the related assets and liabilities. An effective accounting system identifies and records all valid transactions, describes transactions in sufficient detail to permit proper classification for financial reporting, measures the value of transactions in a manner that permits proper monetary recording, records transactions in the proper accounting period, and presents transactions properly in the financial statements.

b. Obtain sufficient knowledge of the contractor's accounting system to understand the classes of significant transactions, how these transactions are initiated, the accounting records, supporting documents, machine-readable information, and the specific accounts involved in the processing and reporting of transactions, the accounting process involved from the initiation of a transaction to its inclusion in cost representations to the government, including how the computer is used to process data, and the reporting process used to prepare the contractor's financial statements and cost representations.

c. Additional guidance on the review and documentation of contractor accounting systems is contained in Chapter 5.

2-305.3 Control Procedures

a. Control procedures are those policies and procedures in addition to the control

environment and accounting system that management has established to provide reasonable assurance that specific objectives will be achieved. These control procedures may be integrated into specific components of the control environment and accounting system. They generally pertain to:

- (1) Proper authorization of transactions and activities.
- (2) Segregation of duties that reduces the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities.
- (3) Design and use of adequate documents and records to help ensure the proper recording of transactions and events.
- (4) Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and files.
- (5) Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, comparison of assets with recorded accountability, computer-programmed controls, and user review of computer-generated reports.

b. Control procedures are often integrated in specific components of the control environment and accounting system. As knowledge is obtained about the control environment and accounting system, the auditor is likely to develop an understanding of some control procedures. Consider this when determining whether it is necessary to devote additional time to obtaining an understanding of control procedures.

c. Additional guidance on the review of contractor procedures is contained in Chapter 5.

2-305.4 Procedures to Obtain Understanding

a. Perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records for each of the three internal control structure elements. It is also important to determine whether they have been placed in operation. The nature and extent of the procedures performed will vary depending on the size and complexity of the contractor, previous audit experience

with the contractor, the nature of the particular policy or procedure, and the nature and availability of the contractor's internal control documentation.

b. Prior experience with the contractor may provide an understanding of its classes of transactions. Inquiries of appropriate contractor personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records used to process those transactions. Similarly, in obtaining an understanding of the design of computer-programmed control procedures, make inquiries of appropriate contractor personnel and inspect relevant systems documentation to understand control procedure design and inspect exception reports generated as a result of such control procedures to determine that the procedures have been placed in operation.

c. The auditor's assessment of inherent risk and materiality for various cost accounts and classes of transactions will affect the nature and extent of audit procedures performed to obtain the understanding. Transactions involving particularly large dollar amounts, and those of an unusual or sensitive nature, should be examined, even though the reliability of the contractor's internal control structure has been established.

d. Internal controls may not continue to be effective, especially as changes occur in a contractor's organization. The auditor may find it necessary at any stage of the audit to make assumptions regarding the reliability of the contractor's internal control structure. When tests disclose that these assumptions are unwarranted, revise the original approach and extend the scope and depth of the tests. Reported changes to the assessment of control risk, at major contractor locations, should be documented on the ICAPS maintained in the permanent file. By employing this technique, the evaluation of the contractor's internal control structure is kept current, and the overall audit program is amended to fit prevailing conditions.

e. Internal auditors often perform a number of services for management, including studying and evaluating the inter-

nal control structure. Although the work of internal auditors cannot be substituted for the auditor's own work, it should be considered in determining the nature, timing, and extent of the review required. In certain circumstances, we may conduct a coordinated audit with the internal audit staff. Requirements to be applied in considering the internal auditor's examinations, or in performing a coordinated audit with them, are discussed in 4-202.

2-305.5 Assessing Control Risk and Designing Substantive Audit Tests

a. Control risk is the likelihood that a material misstatement will get through the internal control structure and into the financial statements and cost representations. Assess this risk by evaluating the effectiveness of the control environment, accounting system, and control procedures set up to prevent or detect misstatements and by evaluating the effectiveness of the design and operation of those policies or procedures in preventing or detecting misstatements. The lower the assessed risk and materiality, the less evidence needed from substantive tests to form an opinion. Substantive tests cover two general classes of auditing procedures to obtain evidential matter: (1) detailed tests of transactions and balances, and (2) analytical review procedures applied to financial information.

b. Use the understanding of the internal control structure and the assessed level of control risk to design substantive tests for auditing the contractor's cost estimates or representations. The auditor should rely on a strong internal control structure and therefore reduce the amount of substantive testing in a particular audit area. For example, as the risk decreases, change the nature and/or timing of substantive tests or reduce the extent of testing. In these circumstances, identify the controls being relied upon, perform tests of the controls to evaluate their effectiveness, and document these tests and the conclusions reached.

c. The auditor may choose not to rely on the internal control structure when planning substantive audit tests because the contractor's internal controls are unlikely to be effective, or because it would

be inefficient to evaluate their effectiveness. In these circumstances, more evidence is needed from substantive tests to form an opinion.

d. The auditor should review internal controls in order to determine to what extent she or he can rely on the accounting records and related contract cost data for both contract costing and pricing purposes. The extent of accounting data tests should be based upon the assessment of the reliability of the contractor's internal controls. Reviews of internal controls, at major contractors, are normally performed and documented in separate audit assignments which are summarized in the Internal Control Audit Planning Summary maintained in the permanent file. When this is not the case, the review should be detailed enough to determine whether policies, procedures, and practices are consistent with applicable laws and regulations and whether the system of internal control can be relied upon to provide reasonable assurance that such policies and practices are being followed.

2-306 Evidence

The auditor's work shall include the examination or development of sufficient evidence to afford a reasonable basis for the auditor's conclusions and recommendations regarding cost representations, management decisions influencing costs, financial statements, or any other matters requiring the auditor's opinion.

a. It is the auditor's responsibility to accumulate sufficient evidence to provide an appropriate factual basis for the conclusions and recommendations. Evidence needed to support the auditor's findings may be (1) observation, photograph, or similar means, (2) interviewing or taking statements from involved persons, (3) documentary evidence consisting of letters, contracts, extracts from books of account, etc., and (4) analysis of information the auditor has obtained. The evidence involved should meet the basic tests of sufficiency, competence, and relevance. The auditor's working papers should reflect the details of the evidence he or she has relied upon and

should disclose the procedures employed to obtain it.

b. Sufficiency is the presence of enough factual evidence to lead a prudent person to the same conclusion as the auditor. Determining the sufficiency of evidence requires judgment because there frequently is conflicting evidence and the auditor must make an impartial judgment as to what position is supported by the weight of evidence. When appropriate, statistical methods may be employed to establish sufficiency. There is no need for elaborate documentation to support noncontroversial or insignificant points. For significant matters, however, the auditor should ensure that he or she has obtained sufficient evidence and show the factors relied upon to reach the conclusion.

c. Competent evidence should be reliable and the best attainable through the use of reasonable audit methods. In evaluating the competence of evidence, the auditor should carefully consider whether there is any reason to doubt its validity or completeness. If there is reason for doubt, the auditor should take additional measures to authenticate the evidence. The following presumptions are useful in judging the competence of evidence; however, these presumptions are not to be considered as sufficient in themselves to reach a conclusion.

(1) Evidence developed under a good system of internal control is more likely to be reliable than that obtained where such control is weak or unsatisfactory.

(2) Evidence obtained by the auditor through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

(3) Original documents are more reliable than copies.

d. Relevance refers to the relationship of the information to its use. The facts and opinions used to prove or disprove an issue must have a logical relationship to that issue. Information which does not have this relationship is irrelevant and should not be included as evidence.

e. The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of applying audit procedures to gather evidence may be influenced by the method of data processing. The auditor can use either manual audit procedures, computer-assisted audit techniques, or a combination of both to obtain sufficient, competent evidential matter. In some accounting systems that use a computer for significant accounting applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance.

f. Statistical sampling techniques will be used in testing selected transactions, whenever feasible.

g. For further details concerning the subject of audit evidence, see 3-104.13 and 4-1003.

2-400 Section 4—Reporting Standards for Financial Statement and Financial Related Audits

2-401 Introduction

a. The AICPA has explained that generally accepted auditing standards are applicable when an auditor examines and reports on any financial statements. The AICPA defines (at AU621.02) a financial statement as "... a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a comprehensive basis of accounting." As a natural extension of generally accepted auditing standards, the AICPA has also promulgated standards for attestation services which are similar but broader in scope.

b. The government auditing standards indicate that the reporting standards of the AICPA as well as the supplemental government standards apply to both financial statement audits and financial related audits. Application of the standards to contract audit reports requires due regard for the purpose and circumstances of the audit. This section identifies the reporting standards and explains how they have been applied in contract audit report guidance.

c. Reporting standards for operations audits are addressed in 2-600.

2-402 Reporting Standards

a. The four standards of reporting under AICPA generally accepted auditing standards are:

(1) The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

(2) The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

(3) Information disclosures in the financial statements are to be regarded as

reasonably adequate unless otherwise stated in the report.

(4) The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility the auditor is taking.

b. The six supplemental government reporting standards are:

(1) A statement should be included in the auditor's report that the audit was made in accordance with generally accepted government auditing standards.

(2) The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It should include all material instances of noncompliance and all instances or indications of illegal acts which could result in criminal prosecution.

(3) The auditors should prepare a written report on their understanding of the entity's internal control structure and the assessment of control risk made as part of a financial statement audit or a financial related audit. This report may be included in either the auditor's report on the financial audit or a separate report. The auditor's report should include as a minimum: (1) the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing the control risk, (2) the entity's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the

financial statements and results of the financial related audit, and (3) the reportable conditions, including the identification of material weaknesses, identified as a result of the auditor's work in understanding and assessing the control risk.

(4) Written audit reports are to be prepared giving the results of each financial related audit.

(5) If certain information is prohibited from general disclosure, the report should state the nature of the information omitted and the requirement that makes the omission necessary.

(6) Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions, ethical considerations, or other arrangements prevent it. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for taking action and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.

c. The AICPA reporting standards for attestations (written communications expressing a conclusion about the reliability of a written assertion that is the responsibility of another party) are:

(1) The report shall identify the assertion being reported on and state the character of the engagement.

(2) The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.

(3) The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.

(4) The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.

d. For reports on an examination of prospective financial statements, the AICPA has published the following content requirements:

(1) An identification of the prospective financial statements presented.

(2) A statement that the examination of the prospective financial statements was made in accordance with AICPA standards and a brief description of the nature of such an examination.

(3) The accountant's opinion that the prospective financial statements are presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast or a reasonable basis for the projection given the hypothetical assumptions.

(4) A caveat that the prospective results may not be achieved.

(5) A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

e. When agreed-upon procedures have governed an audit of financial forecasts and projections, the AICPA has prescribed that the report should:

(1) Indicate the prospective financial statements covered by the accountant's report.

(2) Indicate that the report is limited in use, intended solely for the specified users, and should not be used by others.

(3) Enumerate the procedures performed and refer to conformity with the arrangements made with the specified users.

(4) If the agreed-upon procedures are less than those performed in an examination, state that the work performed was less in scope than an examination of prospective financial statements in accordance with AICPA standards and disclaim an opinion on whether the presentation of the prospective financial statements is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions.

(5) State the accountant's findings.

(6) Include a caveat that the prospective results may not be achieved.

(7) State that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

2-403 Application of the Reporting Standards

DCAA has developed reporting guidance (see Chapter 10) which complies with all aspects of the generally accepted

government auditing standards (i.e., the four AICPA standards and six supplemental standards). The AICPA standards and requirements for attestations, examinations of prospective financial statements, and agreed-upon procedures have been given due regard in developing the report guidelines where the audit objectives and circumstances are similar to those encountered by a CPA public practitioner.

2-500 Section 5—Field Work Standards for Performance (Operations) Audits**2-501 Introduction**

In the contract audit environment, performance audits are more commonly described as operations audits. The objectives of evaluating the economy and efficiency of performance and the attainment of desired results are similar, but the contract auditor emphasizes economy and efficiency as these factors relate to the reasonableness of costs to be charged to government contracts.

2-502 Planning

a. This standard places responsibility on the auditor or audit organization to thoroughly plan an audit. This includes defining the audit objectives and planning how they can be attained while establishing a balance between audit scope, time frames, and staff-days to be spent to ensure optimum use of audit resources. The details of the plan for the audit should be included in the audit program.

b. Adequate planning for operations audits should include consideration of internal audit reports, capital budgets, and other contractor information related to the prospective audit. The criteria for assessing performance should be established. Skill and knowledge of the personnel to staff the assignment must be taken into account, and requirements for the use of consultants, experts, and specialists should be assessed. The audit plan should assure contractor compliance with laws and regulations and provide for detection of potential abuse and illegal acts. Assessment of the effectiveness of the contractor's internal controls is as essential to the planning of operations audits as to the planning of financial audits.

c. Written audit programs are essential to conducting audits efficiently and effectively and should be prepared for each audit. Audit programs provide:

(1) A description of the audit methods and suggested audit steps and procedures to be conducted to accomplish the audit objectives.

(2) A systematic basis for assigning work to supervisors and staff.

(3) The basis for a summary record of work.

2-503 Supervision

a. This standard places responsibility on the auditor and audit organization for seeing that staff who are involved in accomplishing the objectives of the audit receive appropriate guidance and supervision to ensure that the audit work is properly conducted, the audit objectives are accomplished, and staff are provided effective on-the-job training. External consultants and specialists also should be given appropriate guidance.

b. Supervisory reviews of audit work and the report should be timely. Supervisory reviews of the work conducted should be documented in the working papers.

2-504 Legal and Regulatory Requirements

a. One of the primary objectives of an operations audit is to test compliance with laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources and the quantity, quality, timeliness, and cost of the products and services it produces and delivers. An audit to determine the allowability of a contractor's lease cost for electronic data processing equipment under FAR 31.205-2(b)(1) is a specific example of such an assessment. In a broader sense, a primary objective of virtually all DCAA audits is to ensure compliance with FAR cost principles.

b. Auditors should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives. This standard places responsibility on the auditor when assessing compliance with laws and regulations to:

(1) Assess, for each applicable compliance requirement, the risk that abuse and illegal acts could occur.

¶2-504b.

(2) Based on that assessment, design steps and procedures to provide reasonable assurance of detecting abuse or illegal acts.

c. Auditors should be alert to situations or transactions that could be indicative of abuse or illegal acts. When information comes to the auditor's attention (through audit procedures, "tips", or other means) indicating that abuse or illegal acts may have occurred, the auditor should consider the potential impact of these acts on the audit results. If these acts could significantly affect the audit results, the auditor should extend the audit steps and procedures as necessary to determine whether the acts occurred; and, if so, to determine the extent to which these acts significantly affect the audit results.

2-505 Internal Control

a. An assessment should be made of applicable internal controls when necessary to satisfy the audit objectives. The assessment should include a survey of management policies, procedures, practices, and internal controls applicable to any aspect of the activities in which the auditor attempts to judge whether existing practices can be made significantly more efficient or economical.

b. Costs result from implementation of management policies and decisions. Accordingly, the evaluation of these policies and decisions, and the effectiveness of management controls over their implementation, will also significantly influence the scope and nature of the audit. A complete review of internal controls as a specific requirement would often be prohibitive in terms of available resources. Therefore, the auditor should concentrate attention on those controls which are important to audit objectives.

c. Ideally, management policies and decisions should be geared toward prudent, effective, and economical operations and reflect adequate consideration of the interests of both the contractor and the government. Ideal conditions are seldom found. As an illustration, the retention of a large engineering staff during periods of significantly declining sales volume may well serve the contractor's interest in terms of maintaining a capability to expand efforts in bidding for new business. However, unless the auditor questions the increased overhead rate which results from such a decision, the costs of current government contracts will be inflated, thereby adversely affecting the government's interest. Where management policies and decisions are motivated by contractor interests which are not compatible with those of the government, the examination of questionable cost areas should be intensified.

2-506 Evidence

a. Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditors' judgments and conclusions regarding the organization, program, activity, or function under audit. A record of the auditors' work is to be retained in the form of working papers.

b. Working papers may include tapes, films, and discs. Evidence may be categorized as physical, documentary, testimonial, and analytical. The evidence should meet the basic tests of sufficiency, relevance, and competence. The working papers should reflect the details of the evidence and disclose how it was obtained.

2-600 Section 6—Reporting Standards for Performance (Operations) Audits**2-601 Introduction**

The reporting standards explained in this section apply to DCAA operations audits.

2-602 Government Reporting Standards for Performance Audits

a. Form: Written audit reports are to be prepared communicating the results of each audit.

b. Timeliness: Reports are to be issued promptly so as to make the information available for timely use by management and legislative officials, and by other interested parties.

c. Report Contents:

(1) Objectives, Scope, and Methods: The report should include a statement of the audit objectives and a description of the audit scope and methods.

(2) Audit Findings and Conclusions: The report should include a full discussion of the audit findings, and where applicable, the auditor's conclusions.

(3) Causes and Recommendations: The report should include the cause of problem areas noted in the audit, and recommendations for actions to correct the problem areas and to improve operations, when called for by the audit objectives.

(4) Statement Regarding Government Auditing Standards: The report should include a statement that the audit was made in accordance with generally accepted government auditing standards and disclose when applicable standards are not followed.

(5) Internal Controls: The report should identify the significant internal controls that were assessed, the scope of the auditor's assessment work, and any significant weaknesses found during the audit.

(6) Compliance with Laws and Regulations: The report should include all sig-

nificant instances of noncompliance and abuse and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.

(7) Views of Responsible Officials: The report should include the pertinent views of responsible officials of the organization, program, activity, or function audited concerning the auditors' findings, conclusions, and recommendations, and what corrective action is planned.

(8) Noteworthy Accomplishments: The report should include a description of any significant noteworthy accomplishments, particularly when management improvements in one area may be applicable elsewhere.

(9) Issues Needing Further Study: The report should include a listing of any significant issues needing further study and consideration.

(10) Privileged and Confidential Information: The report should include a statement about any pertinent information that was omitted because it is deemed privileged or confidential. The nature of such information should be described, and the basis under which it is withheld should be stated.

d. Report Presentation: The report should be complete, accurate, objective, and convincing, and be as clear and concise as the subject matter permits.

e. Report Distribution: Written audit reports are to be submitted by the audit organization to the appropriate officials of the organization audited, and to the appropriate officials of the organization requiring or arranging for the audits, including external funding organizations, unless legal restrictions, ethical considerations, or other arrangements prevent it. Chapter 10 and 4-300 specify disclosure restrictions applicable to contract audits performed by DCAA.

2-S10 Supplement—Description of DCAA Quality Control System

INTRODUCTION

The Defense Contract Audit Agency's (DCAA)'s quality program is based on the precepts of Total Quality Management (TQM). DCAA's quality control program is an important subset of the Agency's overall quality program. TQM emphasizes "prevention" as a means for reducing errors and rework. However, an adequate level of quality control—monitoring and inspection—is crucial to assure that quality is being achieved. As an agency that provides professional services, DCAA has a responsibility to establish and conform to professional standards. To meet the first part of this responsibility, DCAA has established

standards based on generally accepted government auditing standards which incorporate the standards of the American Institute of Certified Public Accountants. To ensure that it provides professional services that conform with its professional standards, DCAA is required to have a system of quality control and, indeed, maintains such a system. The authority for and descriptive details of this system can be found in the various official pronouncements and Agency publications, including the DCAA Charter, Instructions, Pamphlets, Manuals, and other DCAA directives. A summary description of the system follows.

PHILOSOPHY, ORGANIZATION, AND APPROACH TO PROVIDING QUALITY SERVICES

Philosophy

DCAA is an independent audit agency within the Department of Defense (DoD) with a mission to perform contract audits and provide all the necessary accounting and financial advisory services for the DoD, and other agencies, as appropriate. In accomplishing this mission, the Director of DCAA has fully committed the Agency staff to attain the highest level of integrity, competence, and customer satisfaction. This is best explained through our vision statement set forth as the Agency's Commitment to Excellence, which says:

In support of the National Interest, we are dedicated to providing timely and responsive audits, reports, and financial advisory services to the Department of Defense contracting officers and other customers.

Our aim is to be THE audit organization with the foremost reputation for competence, integrity, and customer satisfaction by:

- o Creating an environment of teamwork, open communication, trust, and mutual respect, and
- o Developing highly qualified employees dedicated to the concept of continuous improvement.

Good working relationships and open communications with customers will minimize potential conflicts between the customer's needs and the Agency's requirement to perform contract audits that conform with generally accepted government auditing standards.

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Organization

DCAA's basic system of quality control encompasses the Agency's organizational structure, as detailed in the DCAA Organization Manual (DCAAM 5110.1), and outlined below.

Headquarters

Office of the Director

DCAA's Director reports to the Assistant Secretary of Defense (Comptroller) and exercises worldwide direction of the Agency in performing all contract audits for DoD and other agencies upon request. The Director's staff includes a Deputy Director, three Assistant Directors, a General Counsel, an Executive Officer, and a Special Assistant for Quality. Note that the Special Assistant is specifically responsible for (1) planning, directing, and supervising the Agency-wide quality program and (2) providing an appraisal of the operational and administrative effectiveness of internal controls for DCAA Headquarters, Regional Offices, and Field Audit Offices (see Inspection below).

Assistant Directors

Operations—Responsible and accountable for providing technical guidance and direction to the Agency for field contract audit operations. This includes directing the conduct of special audits and the development of Agency audit objectives, programs, operational schedules, and priorities to assure effective accomplishment of field contract audit operations.

Policy and Plans—Responsible and accountable for directing the formulation and development of DCAA policy and for the coordination, issuance, and integration of this policy. Assigned divisions include Policy Formulation (PFD), Policy Liaison (PLD), Accounting Policy (PAD), and the Defense Contract Audit Institute (DCAI).

Resources—Formulates, directs, and executes plans, programs, policies, and procedures related to the management of DCAA resources including financial management, personnel management and

administration, automated and non-automated information resources management, management analysis, security, and general administration activities.

Regional Offices and Field Detachment

Office of the Regional Director

DCAA presently has five Regional Directors who are individually responsible and accountable to the Director for planning, managing, and accomplishing the Agency's mission in assigned geographical areas. This includes directing the overall management of DCAA personnel and resources assigned to the individual Regional Offices and to the various Field Audit Offices (FAOs) and suboffices within the regions. Each Regional Director's staff includes a Deputy Regional Director, approximately six Regional Audit Managers, a Special Programs Manager, a Resources Manager, and a Regional Special Assistant for Quality.

Director, Field Detachment

The Director of DCAA's Field Detachment is responsible and accountable for the overall planning, management, and execution of worldwide DCAA contract audits of compartmented programs and for managing all of the resources and staff assigned to the Detachment.

Field Audit Offices (FAOs)

Resident Offices—Are established at contractor facilities whenever the amount of audit workload justifies the assignment of a permanent staff of auditors. Resident Offices, which can be made up of several suboffices of components within the same company, are responsible and accountable for planning and executing a comprehensive, integrated audit program to carry out DCAA's audit mission.

Branch Offices—Are established to plan and execute a comprehensive audit program to carry out DCAA's audit mission at those contractor locations, within

a general geographical area, which individually do not have sufficient workload to justify establishing a Resident Office. Branch Offices are generally organized to cover their smaller contractors from one

central office on a mobile basis. Larger contractors are often covered from sub-offices.

Approach

Auditing in accordance with generally accepted government auditing standards is the principal work of the Agency. To promote the quality accomplishment of this work, DCAA auditors are initially guided to take steps to develop a thorough knowledge of the contractual matters and circumstances affecting their audits. These steps entail:

- o Developing an "intelligence base" on a contractor's operations and contracting environment in order to assess the events and conditions that affect the contractor actions and the government's cost impact.

- o Identifying the audit universe and documenting interrelationships between a contractor's organization and operations so that all significant auditable activities which affect the costs of government contracts are identified.

- o Accurately assessing the strengths and weaknesses of a contractor's internal controls, accounting and management systems, and methods of operation, in order: (1) to identify the relative risk of performing or not performing certain audit workpackages; (2) to evaluate the government's exposure to potential

fraud, waste, and mismanagement; and (3) to tailor audit programs for specific assignments.

- o Accomplishing certain basic, core audit requirements before rendering an opinion on contract costs incurred and before relying on incurred costs in any other review or evaluation. If no weaknesses are disclosed, the satisfaction of these core requirements provides a basic level of assurance that a contractor's incurred cost representations are reliable. If weaknesses are disclosed, audit procedures must be extended accordingly.

- o Determining that contractor systems for estimating prices are adequate and in compliance with applicable regulations.

- o Assuring that all laws, regulations, and authoritative technical guidance for the accounting and auditing professions (including those issued by DCAA) are followed.

- o Continually assessing progress on individual assignments and program areas in order to react timely and positively to changed conditions within the industry, acquisition, and audit environments.

ELEMENTS OF DCAA'S QUALITY CONTROL SYSTEM

Independence

Objective

To provide reasonable assurance that all DCAA employees maintain the level of independence required by the Agency's standards of conduct and by the generally accepted government audit standard on independence.

Policies and Procedures

General Requirements—DCAA employees at all organizational levels must adhere to the requirements on independence as stated in the government audit standard on independence, DCAA Regulations (DCAARs), Contract Audit Manual (CAM), and Personnel Management Manual (PMM). CAM 2-203 incorpo-

rates the government audit standard on independence and prescribes the DCAA auditor's responsibilities for independence when performing contract audits.

Organizational Placement—DCAA has been organizationally positioned within DoD to ensure independence from the various DoD departments and agencies involved in the acquisition process. This provides the independent environment necessary for DCAA to accomplish its contract audit mission. Refer to the preceding section on Organization and CAM 1-1S1 for further details.

Audit Impairments—No factors external to DCAA are permitted to restrict the audit or interfere with the auditor's ability to form independent and objective opinions and conclusions. If a limitation exists, the auditor should remove the limitation or, failing that, report the limitation. DCAA expects each auditor to exercise prudent judgment in establishing audit scope, auditing procedures, and appropriate reporting of results.

Personal Impairments—DCAA employees must maintain a high level of

moral character and observe a high standard of ethical and professional conduct. Consistent with this responsibility, employees are required to refrain from such conduct as any private business or professional activity which conflicts, or gives the appearance of conflicting, with official duties. DCAAR 5500.2 presents the complete standards of conduct for DCAA employees and specific responsibilities for policy implementation. It incorporates the provisions of DoD Directive 5500.7, "Standards of Conduct" and DoD Directive 5500.2, "Policies Governing Participation of (DoD) Components and Personnel in Activities of Private Associations." Chapter 37 of DCAA's Personnel Management Manual (PMM) provides additional procedural guidance and states responsibilities relating to the rotation and reassignment of employees to maintain audit integrity and independence. Employees may be reassigned or rotated without change in grade to assure audit objectivity and independence.

Personnel Hiring

Objective

To provide reasonable assurance that hiring policies and procedures attract the best persons available and result in the employment of individuals who possess the appropriate characteristics to enable them to perform competently.

Policies and Procedures

General—DCAA's policy is to make use of all available resources to assure that the Agency is fully staffed with qualified and competent auditor and administrative personnel. Recruiters must be carefully selected for their ability to represent the Agency effectively and to carry out this policy. The procedural guidance and specific responsibilities for implementing DCAA's recruitment program are contained in PMM, Chapter 11. This guidance covers the candidate sources and criteria for source selection, the college recruitment program, recruit-

ment for intermediate- and senior-level positions, and candidate selection procedures.

Qualifications—Office of Personnel Management (OPM) Examination Announcements provide instructions which include the required qualifications for Accountant and Auditor positions, GS-5 through 12. Qualifications for DCAA's administrative positions are found in the OPM Qualification Standards Handbook X-118 governing the particular occupational series.

Informing Applicants and New Hires—During orientations conducted by the Personnel Office and FAO management, applicants and new hires are informed of Agency policies and procedures relevant to them. A recruitment brochure is also available to any interested person or college recruitment office.

Employee Retention—As an extension of the recruitment process, DCAA invokes a probationary period. If, during

this period, an employee is determined to lack the skills and character traits necessary for satisfactory performance as a career employee, his or her appointment will be terminated. Details on completing an Auditor Probationary Appraisal Re-

port and the procedures relating to actions required by supervisors of new employees in the probationary period are covered in PMM, Chapter 19.

Personnel Assignment

Objective

To provide reasonable assurance that personnel are assigned in a manner that appropriately considers: (1) the staffing plans and requirements for the Agency overall, as well as for individual field offices; (2) the balance of required skills and experience; (3) technical training needs; and (4) the nature and extent of supervision to be provided.

Policies and Procedures

General—Headquarters is responsible for providing the strong, central direction necessary for development and maintenance of a competent, professional staff and for effective utilization of this staff. Staffing positions are established and personnel are assigned at each organizational level to provide an optimum balance among mission needs, economy and efficiency of operations, and effective employee utilization. The Agency's personnel policies and procedures relating to position classification and position management are contained in PMM, Chapter 6. These policies and procedures are compatible with and fully support all affirmative social action programs. Refer to the preceding section on Organization for the general responsibilities of all principal DCAA organizational elements.

Staff Qualifications—DCAA auditors and specialists (see Consultation below) must collectively have the skills necessary to accomplish all aspects of DCAA's audit mission. This requires detailed knowledge of: (1) accounting and auditing theory, principles, procedures, and practices; (2) organizations and contracts subject to audit; (3) government contracting policies and regulations; and (4) management principles and skills. Update and maintenance of the required skills is

accomplished through DCAA's continuing education program (see Professional Development below).

Staff Requirements and Distribution—DCAA's staff requirements are determined based on estimates of the workload and the time required to perform this work in accordance with generally accepted government auditing standards. Appropriate consideration in calculating these estimates must be given to such factors as government financial risk and vulnerability to fraud, waste, and abuse. Guidance for determining staffing requirements is provided annually through issuance of a Headquarters Program Objective Document (POD). This memorandum contains specific Agency direction for determining staffing requirements for the coming year.

The distribution of available personnel within DCAA is based on an evaluation of total Agency workload and priorities, and is made in consonance with the respective workloads of the five DCAA Regions, the Field Detachment, and Headquarters. Regional Offices make distributions to Field Audit Offices (FAOs). A DCAA office is established when sufficient workload exists to justify a separate audit unit without unnecessarily duplicating administrative support requirements (see Organization).

The general guidelines used by DCAA for organizing staff, programming audits, scheduling performance of audit segments, and analyzing progress are contained in CAM, Appendixes G and H, which cover management of mobile audits and management of resident audits, respectively. Detailed programming objectives and guidance are set forth in the annual Program Objective Document.

FAO Assignments—The Field Audit Office or FAO is DCAA's base level organizational unit responsible for pro-

viding financial services and planning and performing contract audits for the DoD and other government agencies. Accordingly, FAO managers have primary responsibility for the assignment of field office personnel while audit supervisors (see Supervision below), reporting to the FAO managers, generally direct the actual planning and performance of the individual audits.

The FAO supervisors, together with the FAO managers, are responsible for considering and weighing many variables and factors when assigning personnel. Some of the more critical variables/factors include the technical diffi-

culty and timing requirements of each assignment and the technical qualifications and availability of personnel.

Reassignment/Rotation—Employees are reassigned to different positions and locations as necessary to accomplish the Agency's mission. In fact, the Agency encourages employees to be mobile in the interest of broadening their experiences and increasing their qualifications. Specific procedures covering employee reassignment/rotation to satisfy Agency objectives are contained in PMM, Chapter 37.

Professional Development

Objective

To provide reasonable assurance that DCAA's professional development program enables personnel to obtain the knowledge required to fulfill their assigned responsibilities and to progress within the Agency.

Policies and Procedures

General Guidelines & Requirements—It is DCAA's policy to systematically plan for and provide all of the training and development of its employees in order to maximize their performance proficiency and to assure they remain current in the profession. Individual organizational elements are responsible for establishing adequate plans and controls to ensure that all training and employee development activities are accomplished economically, effectively, and on a timely basis, in consonance with the Agency's training and development program. This program encompasses: (1) on-the-job training and skill development through carefully planned and more progressively complex employee assignments; (2) formal training, including courses given by DCAI; (3) self-development courses, developed or approved by DCAA personnel and administered by the Regions or DCAI; (4) professional continuing education programs; (5) attendance at short-term training courses on specific subjects

offered by other sources; and (6) self-development through attaining professional certification (e.g., Certified Public Accountant) and advanced degrees (including the Director's Fellowship Program in Management).

Specific procedures and responsibilities for carrying out the Agency's professional development program at all organizational levels are contained in the following PMM chapters:

- Chapter 16 Career Management Policies
- Chapter 17 Performance Management System
- Chapter 21 Training and Development
- Chapter 30 Professional Activities Outside DCAA

PMM, Chapter 21 presents DCAA's Master Training and Development Plan for Auditors. This plan identifies the formal technical and management training, by type and course, which is essential or desirable for progression from one audit career level to another within DCAA.

The knowledge and skills that are required by contract auditors at various grade levels to effectively perform their assigned tasks are detailed in Chapters 16 and 17 of the PMM. These chapters also provide guidance on assessing individual performance and identifying individual training and education needs. As an

integral part of its overall training and development program, DCAA also requires that specific evaluations be performed to assess the extent to which training sources are achieving stated objectives.

Defense Contract Audit Institute (DCAI)—The DCAI is responsible for developing the Agency's training program and courses. Courses provided at the Institute are designed and periodically updated to enable DCAA's auditors and managers to gain the knowledge and skills they need to perform their assigned tasks in carrying out DCAA's audit mission. The courses are also designed to improve performance weaknesses and to prepare employees for higher responsibilities.

Specialization—Training needs are continuously reviewed and updated to meet present and anticipated Agency

needs in specialized areas such as data processing and cost accounting for pensions and insurance. This specialized training is accomplished through the same basic training sources described in the General paragraph above, or derived from working with Agency specialists from Headquarters, Regional Offices, or DCAA's Technical Services Center (see Consultation).

On-the-job Training—This form of training is an integral part of the Agency's overall training and development program and is one of the most important responsibilities of all DCAA supervisors. It provides employees with the opportunity to participate in all types of audit assignments at progressively higher levels of complexity and in different contract audit environments.

Advancement

Objective

To provide reasonable assurance that individuals selected for advancement will have the qualifications necessary for fulfilling the responsibilities they will be called on to assume.

Policies and Procedures

Required Qualifications—The qualifications necessary for the various levels of auditor responsibility within DCAA can be stated in terms of the progressive growth in an individual's technical competence and professional ability. This concept of career development is delineated in PMM Chapter 16. The accounting and auditing knowledge and skills that are essential for the contract auditor at various grade levels to effectively perform the assigned tasks are stated in Chapter 16, appendix B, and Chapter 17, appendix D, of the manual.

Criteria for Evaluating Performance—The performance of most DCAA personnel is evaluated in accordance with Office of Personnel Management (OPM) regulations, as set forth in the Federal Personnel Manual. In many instances, these

OPM regulations have been implemented by DoD Directives and Instructions. The objectives of DCAA's performance appraisal system include identifying the job elements of each position, establishing performance standards relative to the elements, informing employees of the job elements and the performance standards for their positions, and conducting a periodic formal review and discussion of the quality of each employee's work performance in relation to the established performance standards. These objectives and associated DCAA appraisal policies and procedures are presented in PMM, Chapters 9 and 17, for GM and GS employees, respectively.

Advancement Decisions—Selections for promotions are made from among the best qualified candidates, based solely on their relative knowledge, skills, and abilities. Advancement selections to auditor positions GM-13 and above are made in accordance with DCAA's Career Management Program policies (see below). Positions GS-12 and below are filled non-competitively (without using vacancy announcements) by career ladder promotions, as employees demonstrate their ability to perform higher level duties.

Agency guidance on advancement decisions is contained in PMM, Chapter 36, Merit Promotion.

Career Management and Career Boards—DCAA managers and supervisors at all organizational levels are responsible for aiding subordinates in defining career objectives and implementing career plans and for making advancement recommendations (or decisions, when authorized) regarding employees under their supervision. Employees, in turn, are encouraged to familiarize themselves with the operation of the merit promotion program, provide complete and accurate information needed for consideration under the merit promotion program, and periodically review and update their experience records and other personal data maintained by the Personnel Office. Individual careerists must further provide the initiative and energy necessary for development of the skills required in their career field and recognize the advantages of mobility to themselves and the Agency.

A DCAA Career Development Board (CDB) is established at Headquarters

with responsibilities for providing policy guidance and monitoring DCAA's career management planning and programming activity. The CDB consists of senior Headquarters executives who (1) recommend for the Director's approval the establishment or revision of employee development activities which may be expected to improve the operation of the career management program and (2) review lists of candidates for filling all auditor and administrative positions at grade GM-14 and above to determine those best qualified for referral to the Director, who is the selecting official.

Regional Directors are accountable for the effective functioning of their respective Region's career management programs and Career Management Boards (CMBs). Each CMB consists of senior regional managers who recommend any needed revisions in the program to the Regional Director and who periodically evaluate the region's career management programs.

Supervision

Objective

To provide reasonable assurance that supervision of work at all organizational levels results in work performance that meets the Agency's standards of quality. The extent of supervision and review required varies in accordance with the audit circumstances and depends on such factors as complexity of the work, the qualifications of the persons performing the work, and the extent of consultation available and used.

Policies and Procedures

General—The supervision of work at all organizational levels is an important factor in assuring that work performed meets the Agency's and customer's standards of quality.

All management and supervisory personnel must maintain familiarity with certain essential elements of personnel management. These elements include:

managing positions and pay, staffing positions and selecting and assigning employees, evaluating and rating employee performance, training and development of employees, using incentives, maintaining management-employee communications, administering constructive discipline, and administering leave. Details on these responsibilities are contained in PMM, Chapter 82.

Planning of Field Work—Adequate planning requires that appropriate consideration be given to the assignment of personnel. Consideration should also be given to report format and content. Likewise, coordinating the audit with cognizant contractor and government procurement representatives both prior to and during the audit is important. Although aspects of audit planning are presented throughout CAM, Chapter 3 of CAM specifically covers this critical element of supervision and quality control.

In planning and managing audits, regions and FAOs are directed to (1) ensure

that quality performance is emphasized and (2) implement the total audit concept technique (TACT). The procedures embraced by TACT are contained in DCAAP 7641.64, "Audit Management at Major Contractors." While the techniques of TACT are geared to audits of major contractors, the TACT principle (managing audit activities on the basis of an integrated totality) applies equally to audits of smaller contractors. Certain TACT techniques are required and performed annually as part of DCAA's planning process. These include use of (1) the internal control audit planning summary for major contractors and the internal control questionnaire for other contractors. The workpackage risk analysis procedures or WRAP (a quantitative method of identifying the relative risk of performing or not performing audit workpackages) may also be used at the option of the auditor. Details on the use of these techniques are presented in DCAA's Program Objective Document (DCAAP 7045.5), with applicable source references.

Supervision of Field Work—Supervisors are responsible for assuring that the necessary auditing procedures and tests are properly designed and systematically laid out so that they can be understood by the assigned audit staff. Supervisors are required to provide their subordinate staff members with sufficiently detailed instructions to enable them to perform their assigned tasks in a quality manner. The amount of preparatory training and direct on-the-job supervision required on a given assignment will vary according to the subordinate's experience and competence. Due care must be exercised in supervising subordinates and in reviewing their work throughout the audit. Findings and descriptions of audit exceptions should be clearly described and well supported, and recommendations should be responsible and appropriate to the conditions described.

Review of Working Papers and Reports—Supervisory review of working papers and reports is required to ensure

that (1) the auditor conforms to audit standards, (2) audit programs are followed unless deviation is justified, (3) the working papers conform to standards and adequately support the reported audit findings, (4) the auditor accomplishes the audit objectives, (5) the report is prepared in accordance with FAR, and (6) the needs of the customer are understood and considered. Documentation of supervisory reviews must be prepared and retained.

Supervisors must assure that each auditor is fully aware of the CAM auditing and reporting requirements. FAO supervisors are also responsible, along with their FAO and regional managers, for implementing all Headquarters policy guidance memorandums, including those addressing the mandatory annual audit requirements (MAARs) and the use of Agency-wide audit file forms and pro forma audit programs and reports. *Audit file forms represent the minimum* audit quality control documentation needed regardless of the type or size of audit. Headquarters updates pro forma audit programs and reports as new policy guidance is issued. Audit programs are expected to be tailored to the specific assignment and approved by the supervisor.

The full performance level for DCAA auditors is the GS-12 senior auditor position. Experienced GS-12s, however, may be called upon to give on-site work direction to trainees as long as it does not preempt the supervisor's responsibility or unduly interfere or prevent the GS-12 from the timely accomplishment of his/her principal work (i.e., performance of DCAA's most complex audit assignments). For a small group of auditors, GS-12s may be asked to furnish advice and instructions on specific audit programs, tasks, and techniques; plan and review individual work assignments within the scope of the total audit assignment; maintain the status and progress of work assignments; and provide on-the-job training to trainees.

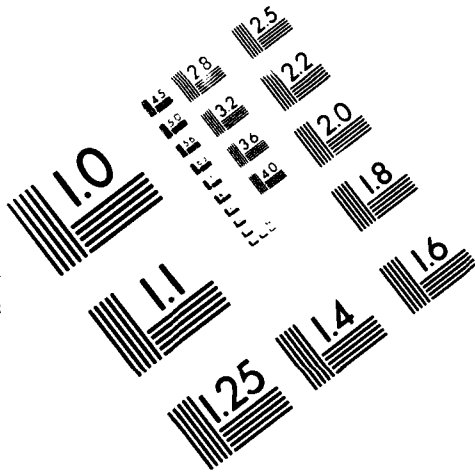
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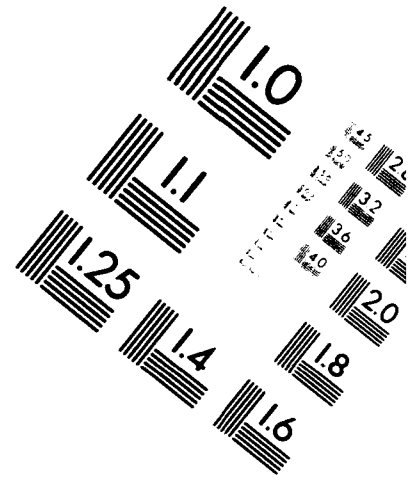


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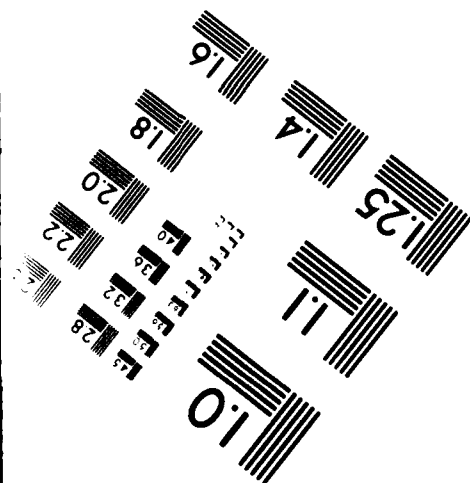
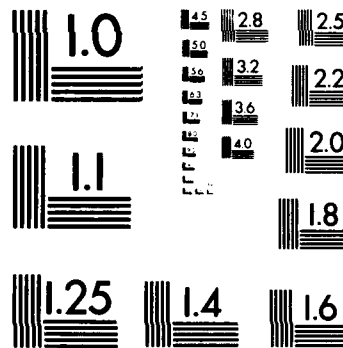
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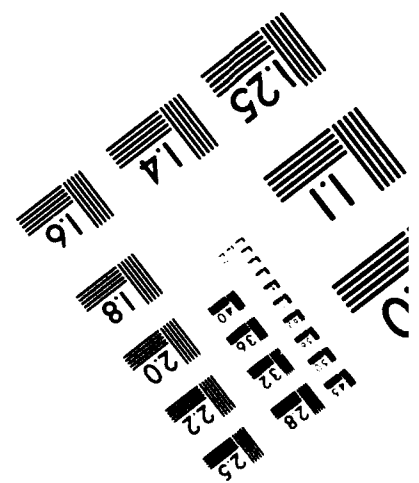
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Consultation

Objective

To provide reasonable assurance that auditors will seek assistance from persons having the appropriate levels of specialized knowledge, competence, judgment, and authority, whenever such specialized assistance is deemed necessary to express an audit opinion and satisfy auditing standards.

Policies and Procedures

General—The auditor is responsible for obtaining sufficient evidence to express an opinion. Since the advice of technical specialists can constitute a significant part of this evidence, auditors must first recognize when areas of an assignment extend beyond their expertise and then obtain assistance from individuals who have the skills needed to evaluate those areas. When specialists are used, the auditor is responsible for satisfying himself or herself as to their professional qualifications and reputation by inquiry or other procedures. Refer to AICPA Standards of Field Work, AU Section 336 (SAS 11), "Using the Work of a Specialist," for this and other considerations in determining the need for consultation.

Sources for Consultation—DCAA auditors may consult with either specialists in a particular field or auditors with specialized experience and training. This includes personnel with specialized technical skills who are assigned to government procurement activities and to attorneys assigned to the Defense Legal Services Agency. It also includes those DCAA employees assigned to the Regional Offices, Technical Services Center (see below), or other Headquarters elements who have specialized experience and training in such areas as electronic data processing, computer assisted audit techniques, pensions and insurance, quantitative methods, and engineering and manufacturing operations. When desired services cannot be performed by present government employees and cannot be obtained through routine civil service procedures, DCAA's policy is to autho-

rize the temporary employment of experts and consultants to obtain the specialized services deemed essential to its mission.

To further support the audit mission, reference libraries with assorted technical and professional publications and other material are maintained in accordance with DCAAR 5000.2. New audit approaches, guidance, and techniques are investigated, developed, and implemented, as required, through research and evaluation conducted by Headquarters and Regional Offices.

Technical Services Center (TSC)—The TSC has been specifically established under the DCAA Assistant Director, Operations, to operate as a focal point for applications research and development activities, and as a source of expertise which is available to field elements engaged in both traditional audits and non-traditional audits. Staffed by computer specialists, engineers, CPAs, and other professionals having the expertise needed to support DCAA's mission, the TSC is comprised of four branches: Electronic Data Processing, Computer Assisted Audit Techniques, Systems Design and Development, and Special Programs.

Requests for Consultation—DCAA's goal is to minimize the number of reports in which we have to express a qualified audit opinion because of a lack of specialized knowledge or skills. DCAA evaluations of price proposals frequently require specialized technical assistance from the cognizant procurement or contract administration activities. Therefore, with few exceptions, requests for this type of assistance are routinely handled. That is, when determined necessary, they are made orally or in writing to the cognizant servicing activity (CAM 9-103.1). With regard to requests for technical assistance to perform an incurred cost audit or operations audit, it is DCAA policy that the auditor will request the assistance from the contract administration activity responsible for the contractor being audited (CAM 2-202a). Requests for specialized assistance from Regional Offices, Headquarters, or

from the Defense Legal Services Agency are accomplished through Regional Office channels. Arrangements for using other non-government specialists are made through the Regional Offices and Headquarters in accordance with DCAAR 1442.1, "Guidelines for the Employment of Experts and Consultants," or DCAAHI 1442.1, "Administrative Procedure for Engaging Actuarial Consulting Services." To avoid misunderstandings, contractor representatives are generally advised of plans to employ specialists for specific reviews. Objections raised by contractors on the use of consultants are discussed with the cognizant Regional Office.

Results of Consultation—The results of a technical review performed by a specialist are expected to be sufficiently detailed for the auditor to satisfy his or her reporting requirements and to include in a final consolidated audit report. To ensure that the results are correctly reported, the auditor must (1) examine them in light of all known facts, (2)

understand the methods and assumptions used by the technical specialist, and (3) attain assurance that the technical findings are appropriately applied in relation to the contractor's financial representations.

Where the results do not appear to be correct or complete, the situation is discussed with the specialist, and any remaining significant differences of opinion are elevated to the Regional Office. Issues that cannot be resolved by the Regions are forwarded to Headquarters in a timely manner. Especially difficult accounting or cost principle issues that cannot be answered using existing regulations and reference sources are referred by Headquarters to the responsible authoritative body for clarification or other appropriate action. Note that all appropriate files documenting the resolution of any significant differences of opinion are required to be maintained for reference and research purposes.

Inspection

Objective

The major objective of the DCAA quality control program is to provide required assurances of financial integrity and quality mission performance in the most efficient and economical manner. This assurance is attained through the coordination of all vulnerability assessment, internal control review, external audit followup, audit quality review, and management improvement efforts. Responsibility for the coordination rests with the DCAA Special Assistant for Quality (see Organization above), who is an experienced audit management official and also DCAA's senior management official for the Internal Management Control Program under the Federal Managers' Financial Integrity Act.

Policies and Procedures

Direct responsibility for quality in all audit and resource management functions is vested in the line and staff

managers and supervisors at all levels of DCAA. Under the general direction of the Deputy Director, the Special Assistant for Quality centrally manages a DCAA-wide quality control program. This Headquarters-directed program is complemented by similar programs directed by the Regional Directors and the Director, Field Detachment.

The quality control program provides timely feedback to all levels of management on the state of compliance with the preceding objectives, policies, and procedures. It also provides a focal point for tracking the implementation of corrective action plans established by management when noncompliance problems have been disclosed by external reviews or internal quality control activities.

Quality control review planning considers the universe of all audit and resource management functions at all organizational levels. Areas for review are prioritized on the basis of periodic full-scale vulnerability assessments, supplemented by data monitoring at the Head-

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quarters level and continual input of any other indicators from any source. The assessments consider the coverage and results of external audits and oversight reviews such as those by the General Accounting Office, the Department of Defense, Office of the Inspector General, Office of Personnel Management, the Information Security Oversight Office, the Office of the Secretary of Defense, and the Office of Government Ethics, to avoid duplication. Depending on the nature of the area to be reviewed, it may be covered by (1) onsite visits to lower-tier offices by Headquarters or Regional Office program managers or functional specialists; (2) fact-finding by cognizant line or functional staff managers or su-

pervisors using such tools as centrally directed survey instruments and internal control checklists; (3) Headquarters desk reviews of sample transaction/event packages called in from Field Audit Offices (for example, audit reports or working papers); (4) onsite review of internal systems by DCAA specialists who normally support our contract audit function, such as EDP technicians or industrial engineers; or (5) review by peers from outside the organization being reviewed, including outside DCAA if required. All review results, with corrective action recommendations if needed, are reported to the Director and Deputy Director and other executives affected.

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CHAPTER 3

3-000 AUDIT PLANNING

3-001 Scope of Chapter

This chapter presents general concepts and techniques of contract audit planning. Section 1 covers such fundamentals as the audit assignment, the audit program for a specific assignment, factors influencing the audit scope, the types, sources and relative quality of audit evidence, and an introduction to use of quantitative methods and electronic data processing (EDP) in contract audits. Sec-

tion 2 provides guidance on briefing the contract and reporting contract provisions which would impede contract audit or administration. Supplement 3-S10 presents illustrations of significant contract audit findings and recommendations that can result from sound planning and effective performance of the contract audit mission at both major and nonmajor contractors. Supplement 3-S20 presents areas of audit coverage desired at NASA contractors.

3-100 Section 1 — Introduction to Contract Audit Planning

3-101 Scope of Section

This section discusses the audit assignment; factors influencing the audit scope; preparation of the audit program, the types, sources, and relative quality of audit evidence; and the use of quantitative methods and EDP in contract audits.

3-102 The Audit Assignment

a. An audit assignment is an authorization to perform a particular phase or aspect of the contract audit responsibility at a specified contractor. It includes a summary statement of the audit objectives, identifies the person or office requesting the audit, the date required, and other pertinent information which will assist in the development of the audit plan.

b. Individual audit assignments can be FAO initiated, established based on requests from internal/external customers or a combination of the two. Typical circumstances which may lead to an audit assignment include (1) a customer request for audit; (2) established contract audit requirements; (3) a new proposal, contract, or contract change; (4) a contract termination; (5) continuous system/operation audit requirements; and (6) changes in contractor's organization, operational procedures, or accounting and estimating policies. The auditor at all levels should always be alert to

identify and report any instance where in her or his judgment an audit is needed to protect the government's interest.

c. The overall audit plan at a major contractor should normally consider requirements for completion of current year and prior year audits of incurred costs by fiscal year. Plans for the completion of incurred cost audits may group prior years' effort as single audits. Audits programmed at major and nonmajor contractors may include one or more assignments established to review individual audit areas of the contractor's system(s). Each assignment should include appropriate audit programs and working papers documenting work accomplished. Each assignment should also be cross-referenced to other assignments established to review individual audit areas of the contractor's system(s). This should ensure that each audit assignment file stands alone without unnecessary duplication of documentation.

3-103 The Audit Program

a. After discussing and documenting the objective, risk assessment, and general scope of the audit assignment with the supervisor, the auditor will prepare the audit program. The audit program is a written plan for orderly accomplishment of the audit assignment and, when completed, is a permanent record of the work done. It reflects a mutual understanding

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between the auditor and supervisor on the scope required to meet government auditing standards and objectives for the assignment. The audit program applicable to incurred cost audits involving multiple workpackages to cover a contractor's fiscal year should be a control document.

b. The program, as initially prepared, indicates the steps to be performed and the estimated time to complete each step or group of steps, and provides for recording actual time, working paper reference, date completed and by whom, evidence of supervisory review and the date, and an explanation of any work not completed as programmed. After the audit program is prepared, it must be submitted for supervisory review prior to starting the field work. Field work normally should not begin until the audit program is approved to ensure that no misdirected or unnecessary effort is expended.

c. Sufficiently describe the audit steps to be performed to indicate the purpose of the step, the manner in which the work is to be done, and the extent of the review.

d. During the audit, cross-reference each audit step to the working paper(s) where the step was accomplished. Also record the actual hours expended on each step or group of steps, when completed, and by whom.

e. As the audit work progresses, and a need for additional work or changes in the program becomes evident, make appropriate adjustments after coordinating them with the supervisor.

f. On completion of the assignment, make sure that all steps are either cross-referenced to working papers or annotated for why they were not done. Also make sure that all actual hours are accounted for by step or group of steps and agree with the time reported in the DCAA FAO management information system (FMIS).

3-104 Factors Influencing the Audit Scope

The auditor is expected to exercise professional judgment, considering vulnerability and risk, in determining the

audit scope. Several factors which may influence the audit scope include:

a. audit objectives and the request for audit.

b. the type of audit.

c. previous audit experience at the contractor.

d. known deficiencies that may affect the audit area.

e. the materiality of the direct costs.

f. the extent of government business subject to audit and its relationship to the contractor's total business is an important consideration when auditing indirect expenses. When auditing service-center-type costs, the consideration should first include a determination of the basis of allocation so that a proper application of the participation rate may be made.

g. the contractor's organizational and capital structure, its business cycle, contract types and mix.

h. the similarity of items being produced for the government to those being produced for others.

i. the contractor's various systems used to accumulate, allocate, report, and control costs.

j. the adequacy of the contractor's internal control structure which includes the control environment, the accounting system, and control procedures. See Chapter 5 for additional guidance on reviewing the internal control structure.

k. the degree of technology and automation used by the contractor.

l. the types and flow of transactions.

m. the types, sources, and relative quality of audit evidence.

n. the extent of knowledge obtained from the review of the contractor's disclosure statement and audit reviews for compliance with applicable Cost Accounting Standards (see 8-000) and FAR Part 31.

o. MAARs accomplishment (see 3-104.16).

p. use of quantitative methods and EDP.

q. RFP/RFQ or Contract provisions.

3-104.1 Audit Objective

a. The purpose of the audit, or audit objective, will often determine the extent of testing as well as the steps required to accomplish the objective. The objective

may range from only gathering specific data to expressing an opinion on the contractor's entire operations. Accordingly, the audit scope may be limited to gathering data or expanded to a comprehensive review of several functions within the contractor's operations. Additionally, the scope may change depending on what the auditor finds during the audit. Regardless, the audit scope must be sufficient to develop an informed opinion on the audit objective that will satisfy the needs of the potential users of the audit findings.

b. The needs of the potential user should be identified in the request for audit and should be considered in defining the audit objective and resulting audit scope. If the requester identifies specific areas of concern, include audit steps which will develop information to answer those concerns. If the specific concerns cannot be answered during the audit, immediately notify the requester. If the necessary steps are beyond the auditor's expertise or ability or require significantly more than normal audit effort for the type of audit planned, coordinate with the requester to either clarify the request and its impact on the audit or suggest alternative sources for the needed information (such as a technical evaluation).

3-104.2 Type of Audit

The type of audit will affect the degree of risk to the government and resulting audit scope. For example, in a price proposal audit, a proposed cost-type contract will generally involve a low risk of overstatement because the contractor will be paid its incurred costs under the contract as long as they are allowable, allocable, and reasonable. One risk is that the costs are understated in the proposal (as in the case of a buy-in). However, in an incurred cost or systems audit, a cost-type contract will generally involve a high risk of overstatement for the same reasons.

3-104.3 Audit Experience

When developing the audit scope, review the permanent file (including assessments of internal control system and control risk summarized on the internal control assessment planning summary

sheets or internal control questionnaires, and audit lead sheets) and prior audit workpackages to determine what data are available, what audit steps were done in the past, and the findings from those steps. This may identify areas where additional audit work is advisable (i.e., areas of high risk) or where audit scope can be reduced (i.e., areas of low risk).

3-104.4 Known Deficiencies

A review of prior audits may disclose known deficiencies. All such deficiencies must be considered when preparing the audit program, paying particular attention to those which have potential impact on the audit area. Include sufficient audit steps to determine whether the deficiencies still exist (i.e., the contractor may not have taken any corrective actions or may have taken actions which did not adequately correct the deficiencies) as well as determine the impact of the deficiencies on the audit results.

3-104.5 Direct Costs

Since direct costs are the basis of the indirect allocation, direct costs are more significant than indirect costs.

3-104.6 Extent of Government Business

a. When the dollar value of the government's interest in the contractor's operation is significant, evaluation of management controls and decisions affecting the economy and efficiency of the contractor's operations takes on added importance. The audit scope should include a review of the considerations which motivate a contractor to choose one course of action over others to achieve a cost objective, and the means by which all management echelons control both direct and indirect cost levels. When the total costs charged to government contracts are not significant, the audit effort need not be as comprehensive in the area of management controls and may be directed more toward the selection of specific cost elements, based on significance and sensitivity, for review and analysis to determine the costs' acceptability.

b. When the preponderance of the contractor's costs is recovered through government cost-reimbursement type contracts and fixed-price contracts which

3-104.6b.

provide for price adjustment, give particular attention to the effectiveness of management cost control. Cost-plus-fixed-fee contracts do not provide the contractor with a direct incentive to minimize costs. Similarly, redeterminable fixed-price contracts do not provide a strong incentive to maintain contract costs below the ceiling price except for incentive sharing provisions. On the other hand, when the bulk of the contractor's work consists of commercial business and firm fixed-price government contracts, competition and the desire to maximize profit, influence the contractor toward instituting prudent business decisions and practices to minimize costs. When cost-reimbursement and fixed-price contracts awarded to the contractor include incentive clauses, the auditor can place more reliance on the profit motive to encourage proper management control over costs. However, the extent of the audit effort in each situation should be sufficient to enable the auditor to determine the reasonableness of the contractor's policies, procedures, and practices influencing costs to assure they maximize economy and efficiency of operations.

c. Also to be considered is the mix of the above contract types in the contractor's business. A preponderance of one type or similar types will generally reduce the risk of mischarging or misallocating costs between contracts. Conversely, a variety of contract types increases the risk of mischarging or misallocation of costs, usually to the cost/redeterminable contracts from the fixed-price/commercial contracts. Therefore, the audit scope must be adjusted accordingly.

3-104.7 Organizational and Capital Structure

a. The contractor's capital structure also can affect the audit scope. When its working capital is insufficient to support its daily operations or there is a cash flow problem, the risk increases for the mischarging or misallocation of costs to those contracts which have interim financing provisions.

b. Similar problems may arise as a result of the contractor's business cycle. If its normal business is extremely cyclical,

there may be a tendency to mischarge or misallocate costs to its government contracts to help it through the low portion of the cycle. Therefore, sufficient testing of transactions must be done to assure that such actions are not occurring.

3-104.8 Similarity of Product

When the end items produced for the contract under audit are similar to end items produced commercially or for other government contracts, place audit emphasis on the equity and consistency with which the contractor identifies direct costs with the various contracts and products. When the work performed under a government contract differs substantially from other production, place audit emphasis on the consistency of direct charging and the use of proper bases to allocate indirect costs.

3-104.9 Indirect Cost Allocation Bases

The contractor's selection of bases for the allocation of indirect costs may have a substantial effect on contract costs.

3-104.10 Contract Financial Management

Contract financial management relates to the overall financial controls maintained by the contractor on individual contracts. It ties to the detailed controls maintained by the contractor at the various management levels and assures that timely data are generated to disclose, among other factors, when estimated costs at completion will be substantially greater or less than the contract price. In this manner, both the contractor and the government would be in a position to adequately consider available management alternatives and make informed decisions concerning (1) whether additional funds are available and will be used on the contract, (2) the possible availability of funds on the existing contract for reprogramming to other projects, and (3) the feasibility of adjusting the requirements under the existing contract through changes in the scope of work or technical trade-offs. The audit scope should include steps to review the adequacy of the contractor's financial management systems. Further guidance on this area is in Chapter 11.

3-104.11 Adequacy and Complexity of the Contractor's Systems, Policies, Procedures, and Internal Controls

a. The adequacy of the contractor's internal control structure including the control environment, the accounting system, and control procedures is an important factor in determining the audit scope. Adequate controls, sound policies, and the effective implementation of prescribed policies and procedures contribute to the reliance that the auditor can place on the contractor's cost representations, and permit reduction of the extent of verification which might otherwise be required. See Chapter 5 for guidance on the review of contractor systems of internal controls.

b. More formalized systems, such as the accounting, estimating, and purchasing, with strong self-controls built into those systems can reduce the audit effort required to satisfy the audit objective once the system has been reviewed and determined to be adequate. Poorly defined or nonexistent systems, or those which rely on external controls only, increase the risk for cost mischarging or misallocation and should correspondingly result in an increase to the audit scope.

c. Additionally, the internal control structure may affect the audit scope. If there is little separation of duties and responsibilities or if the separation is not conducive to adequate internal controls, there is greater risk for costs to be mischarged or misallocated. The control environment may be such that the same management has responsibility for and control over multiple contracts and can manipulate the allocation of costs to those contracts to the government's detriment. Also, if the internal control structure changes frequently, the audit scope must be expanded to assure that the change(s) have not adversely affected contract costs.

d. When reviewing the contractor's internal control systems, auditors should consider (1) the amount of systems testing previously performed or currently planned by other government agencies or independent reviewers, such as public accounting firms; and (2) contractor self-governance, such as application of the

Contractor Risk Assessment Guide (CRAG) or other self-governance programs.

e. The CRAG is a voluntary program initiated by the Secretary of Defense to strengthen DoD/industry communication, improve government oversight of contractors, encourage contractor self-governance, and communicate DoD oversight criteria. Five contractor risk areas have been identified in the CRAG: indirect cost submissions, labor charging, material management/accounting systems, estimating systems, and purchasing systems. The CRAG provides control objectives, major controls, and commonly used control procedures for each of the risk areas. Using the CRAG as a guide, contractors may test their own internal control structure and provide the testing documentation and results to the government. Auditors will determine the extent to which they can rely on the materials provided by the contractor in accordance with government auditing standards (See 4-1004). Under CRAG, auditors will disclose the reasons for reliance or non-reliance to the contractor. Where the contractor's effort can be relied upon in accordance with the auditing standards, the auditor will reduce the scope of audit appropriately. The amount of reliance or the reasons for not relying on contractor self-governance efforts should be thoroughly discussed with the contractor. Close coordination with the contractor, from the planning of the annual audit effort through the planning and execution of specific audits, is required to utilize CRAG efficiently and avoid duplication of effort.

3-104.12 Degree of Technology and Automation

The degree of technology and automation used by the contractor in its operations can affect the audit scope also (see 4-500 for use of EDP in contract auditing). Generally, the more sophisticated the contractor's technology and automation, the greater will be the reliability of the resulting data. However, the reliance cannot be blind; greater sophistication also can open doors to greater risks for mischarging or misallocating costs through multiple transactions hiding the

13-104.12

results "in the computer." Generally, the audit trail becomes less distinct as the contractor's systems become more advanced. Therefore, the auditor must consider the results of prior audits, if any, of these sophisticated systems in determining the audit scope.

3-104.13 Types and Flow of Transactions

The types of transactions which the contractor processes through its systems obviously affect contract costs. They also affect the audit scope. When transactions are generated externally, such as materials and outside services purchases, the audit scope is often limited to verification to supporting records for the transactions. There is usually documentary evidence created by an "arm's length" party that substantiates the claimed costs. When the transactions are generated internally, as with labor costs or cost transfers, the audit scope is usually more extensive. Not only are the supporting records verified, but the entire system for cost incurrence, identification to cost objectives, authorization and approval, control, monitoring, and allocation must be evaluated to ensure the validity of the costs. Additionally, the flow of the transactions through the system must be considered. If a transaction flows through any level responsible for cost control, there is increased risk of cost misallocation.

3-104.14 Types, Sources, and Relative Quality of Audit Evidence

a. The quality of available evidential matter will influence the audit scope. Evidential matter, in contract auditing, is all or any part of the body of evidence (records, data, observations, or any other information) which underlie or support a contractor's cost representations, or which may be useful in evaluating the representation. Certain types of evidence have more significance than others; thus, a small quantity of high quality evidence may be a more acceptable basis on which to form an opinion than a large quantity of lesser quality evidence. To determine the quantity of evidence required, the auditor must evaluate the quality of the types of evidence available. A single type of evidence evaluated by itself may estab-

lish an inference, but the acceptability of the evidence is greatly increased by interrelating and reconciling several kinds of evidence. The following guidelines are useful in judging the relative quality of evidence:

(1) Evidence obtained from an independent source is more reliable than that secured from the contractor.

(2) Evidence developed under a good internal control structure is more reliable than that obtained where such control is weak or unsatisfactory.

(3) Evidence obtained through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

(4) Original documents are more reliable than copies.

b. For example, a controller's written statement explaining how costs are allocated to contracts by a computer program is not sufficient by itself, to use as the basis for an opinion on the reliability of the generated costs. This is the poorest quality evidence, since it is testimonial and is generated by the contractor. A written manual, even if prepared by an outside computer programmer, documenting the program's operation also alone is not sufficient. While it is better quality evidence since it was prepared by an independent source, it is still not sufficient alone to satisfy the audit objective; however, it may be used as corroborative evidence with the controller's statement. But even the two together are not sufficient evidence to base an opinion on the costs. Testing of several transactions processed through the program are necessary to assure that costs are being allocated as they should. The testing alone may be sufficient (i.e., relatively better quality evidence since it is directly obtained), but also may require further evidence to develop an opinion. These tests combined with the other two pieces of evidence may be sufficient on which to base an opinion.

c. Audit Evidence Developed by the Contractor. This includes (1) accounting and statistical records and supporting documentation, including minutes of the board of directors and other management meetings, collateral memorandums and documents incidental to and supporting

the recorded or anticipated transactions, budgets, management records and reports, and tax returns; and (2) formal or informal statements of policies and procedures relating to the contractor's accounting, management, and operations. The quality of the contractor-developed evidence is dependent in part on the adequacy of the contractor's internal control structure.

d. Auditor-Developed Evidence. Auditor-developed evidence includes information obtained orally, by examination of books, records, files, and/or statistical data, and by physical observation. This type of evidence also includes direct confirmations with third parties (e.g., verification of vendor quotes directly with the vendor).

e. Contractor Ledgers and Journals as Evidence. To express an opinion on the contractor's representations of incurred costs, the auditor should have evidence that the (1) costs claimed are supported by entries in the ledger accounts, (2) account totals correctly summarize the detailed entries, and (3) entries in the accounts represent a proper accounting interpretation of transactions. The chain of evidence extends from documents describing individual transactions through the books of original entry to ledger accounts and to the cost representations. The reliability of ledgers and accounts as evidence is dependent on the soundness of the principles and policies upon which the records were developed and on the adequacy of internal controls exercised in the preparation and review of the records. Auditors should constantly be alert for potential manipulation of contractor ledgers and accounts. One example would be the removal of pages containing transactions that management or others do not want the auditor to review from a computer listing. If such a listing includes many transactions, it would be difficult to manually verify the accuracy of the totals at the end of the listing. Use sampling procedures described in Appendix B can provide reasonable assurance of detecting material misstatements or fraud.

f. Documents as Evidence. The review of documents is an important step in developing audit evidence. In evaluating

a document as evidence, the auditor should consider the source of the document and the controls used in its preparation and processing.

g. Physical Observations as Evidence.

(1) Physical observation is the actual observance of the work being performed, the physical inspection of facilities such as the buildings and machinery, and the counting of certain assets such as inventory items. The results of physical observation usually are considered good quality evidence.

(2) Among the objectives of physical observation are (a) to ascertain the physical existence of a particular item(s), (b) to inspect an item(s) to determine whether it is being used for the purpose for which it was obtained and the extent of its use, and (c) to assist the auditor in determining the extent of testing and verification necessary to arrive at an opinion regarding the allowability of costs generated by the area under review.

(3) Physical observation may disclose idleness of facilities or personnel and uneconomical and inefficient operating methods. Actual observation is the best evidence of the physical existence of an item, but observation alone is not conclusive as to the reasonableness, allocability, or allowability of the related costs.

(4) Plant or functional observations, including inventory observations, employee interviews, floor checks, perambulations, purchases verification, and similar techniques of physical observation are integral parts of an audit and are applicable in the audit of costs, evaluations of proposals, and the audit of terminated contracts.

(a) Plant or Functional Observations. This term usually applies to the visual appraisal of functions in a contractor's offices, plant, and other work areas and is accomplished by on-site review of practices. The objectives of these observations are to (i) relate actual practices to prescribed procedures, (ii) ascertain the degree of internal control exercised during the actual performance of the function, (iii) assist in determining the extent of reliance that can be placed on the results generated by the function, and (iv) determine the degree to which the function contributes to the economy and

efficiency of the contractor's operations as a whole. Well-planned plant or functional observations are important steps in carrying out the auditor's responsibility for designing tests and procedures which will detect fraud. Unannounced physical observations should be programmed as an integral part of the audit. The auditor should be alert for evidence of fraud, waste, or mismanagement (see 4-803). This technique is especially useful in audits of receiving, production, material control, and engineering areas. (Also see 6-310, 6-312, 6-405, and 6-608.2.) Record the details and conclusions of the observations in the working papers and promptly compare them with the related accounting records. Specific guidelines for each of the major cost elements are contained in Chapter 6.

(b) Employee Interviews and Floor Checks. This term usually applies to the physical verification of labor charges. Specific guidelines for performing employee interviews and floor checks are in 6-400.

(c) Perambulation. This term usually applies to an informal type of plant observation which affords a good opportunity to uncover inefficient and uneconomical practices that might otherwise go unnoticed. It permits the auditor to observe activities and note anything that is unusual. Planning for perambulation requires a determination as to the frequency and geographical area of coverage, but does not contemplate specific objectives. For example, the auditor may observe a major plant rearrangement of which he/she was previously unaware. The auditor should make further inquiries and ascertain the circumstances leading to the plant rearrangement and determine its effect on government contracts.

(d) Tour of the Manufacturing Floor. This term applies to a type of plant observation which affords a good opportunity to view manufacturing processes and practices on a periodic basis to develop a better understanding of the processes and monitor trends in manufacturing processes and practices. Some contractors have established substantial technological advancements on the factory floor, causing changes in the processes and the machinery by which they manu-

facture their products. These changes in manufacturing operations can cause changes to the flow of costs, raising the question as to whether the contractor's cost allocation practices continue to provide equitable distribution of costs to final cost objectives. As a result auditors need to enhance their awareness and understanding of the implications of technical changes on the factory floor. Auditors should tour the contractor's manufacturing facilities periodically (several times a year) to view the machinery and manufacturing practices currently in use. If possible, have the contractor participate in at least one tour a year to explain both its current practices and the evolving changes. This will aid the auditor in developing a better understanding of the manufacturing process and in developing a baseline to determine if the contractor has changed its manufacturing methods.

(e) Purchases Verification. This term usually applies to the physical verification of purchased materials and services. Specific guidance for performing purchases verification is in 6-305.

h. Comparisons and Ratios.

(1) Comparing the amount of an expense for the current period with the corresponding amount for the preceding periods develops corroborative evidence. A comparison of costs by element can provide an overview, an order-of-magnitude frame of reference for direction of audit effort, and other audit planning/performance considerations. For example, assume that certain individual expense elements for prior fiscal periods were determined to be reasonable and acceptable; if the expenses of the current fiscal period compare favorably with those for prior fiscal periods, and if the level of operations and other factors are comparable, such a condition could be considered as a basis on which to form an opinion as to the reasonableness of current expenses. On the other hand, if comparison indicates that a particular expense element had been maintained at a relatively steady level over an extended period, but increased significantly in the current period without any apparent increase in the production volume or an offsetting decrease in another related cost

element, it would indicate that further audit effort is necessary to prove the validity of the current costs.

(2) In addition to comparing the same cost elements between periods, the auditor should also consider the correlation of cost items with appropriate bases. (See Appendixes E and F.)

i. Oral Evidence.

(1) Generally, oral evidence is useful in disclosing situations that may require examination or may corroborate other types of evidence already obtained by the auditor. Oral evidence can determine audit direction and, when appropriate, should be recorded and made part of the audit file.

(2) Do not rely on this type of evidence to completely support an audit conclusion or opinion; use other confirming evidence, particularly where the matter is significant.

j. Other Sources of Evidence. Industry statistics, government and independent studies and publications, and other sources of audit evidence may be available as indicated by the nature of the specific assignment and the auditor's resourcefulness (see 4-1003).

3-104.15 Planning in Connection with Cost Accounting Standards

Audits performed in connection with the contractor's disclosure statement and compliance with CAS (see Chapter 8) can be extremely useful in establishing the audit scope of other assignments by providing improved visibility into the contractor's organizational cost structure, the relationship between direct and indirect costs, and other cost accounting policies, procedures, and practices. FMIS CAS Compliance Testing Reports included in the permanent files provides an overview of the status of a contractor's compliance with CAS and helps identify specific areas needing consideration.

3-104.16 MAARs Accomplishment

A general discussion of MAARs appears in 6-100; a tabulation of the MAARs which includes title, classification, objectives, purpose, and principle CAM reference, appears in 6-1S1.

a. Transaction test and some special purpose MAARs are most likely to be

covered in historical audit assignments. The scope of such reviews are affected by the strength of the controls in the area and the currency of audit experience. Controls affecting each of these MAARs are evaluated in at least one of the internal control areas mentioned in Chapter 5. It is often possible to reduce the scope of a mandatory review when controls in the area are strong or to expand the scope of any review for the purpose of resolving other vulnerabilities identified through risk assessment procedures.

b. Procedures associated with permanent file update and reconciliation MAARs may be budgeted and accomplished as a part of the control or summary assignment for the audit. Permanent file updates are generally performed as part of routine audit assignments.

c. The review and evaluation of the contractor's financial statements, corporate minutes, tax returns (see 3-1S2), and reports filed with regulatory bodies, such as the Securities and Exchange Commission (SEC) (see 3-1S1) will assist the auditor in planning the audit more effectively. MAAR No. 4 requires the auditor to review applicable tax returns and financial statements, including the statements of cash flow of the contractor on an annual basis. In consonance with the concept of the relative value of evidential matter under government auditing standards, the auditor should attach greater value to financial statements and/or reports audited by independent auditors. Similarly, greater value should be placed on corporate reports to regulatory bodies and Federal tax returns because of the severe penalties assessed for noncompliance with reporting requirements. Further discussion of the relative quality of audit evidence is contained in 2-300 and 3-104.14.

d. Reports and Financial Statements. Reports and financial statements, including the statements of cash flow prepared by contractor personnel or outside accountants, may indicate the extent of review and areas covered and may reduce the extent of audit effort or direct attention to specific areas needing examination. As noted in 3-1S1, SEC reports are available to the public. Copies of such

reports are normally kept at the contractor's corporate office and should be available to DCAA on request. Information relative to government contract costs should be extracted from the SEC filings for use on pertinent audits. For details on the procedure to be followed in transmitting information in SEC filings to participating divisions within a CAC network, see 15-205.

e. **Corporate Minutes.** The minutes of board of directors' meetings reflect major decisions by the board of directors concerning the contractor's organization and its operations. Many of these decisions affect contract costs such as organizational structure, plant layout, budgeting, make or buy, plant cutback or expansion, lease vs. purchase, and personnel policies and compensation. Field auditors must be aware of these management decisions to properly plan and develop their audits. Auditors will coordinate, when appropriate, with the corporate or home office auditor to obtain written results of such reviews. When applicable, sensitive issues will be promptly reported to the contracting officer so that advance notice may be given the contractor regarding potentially unallowable costs.

f. **Tax Returns.** It is essential that the auditor perform an annual review of the contractor's tax returns or assure that a review is accomplished by coordinating with the cognizant corporate/home office auditor (see 3-1S2). Results of such reviews will be obtained in writing for inclusion in the audit files. Review of state and Federal income tax returns may indicate possible areas requiring further attention. It may also provide information on differences between costs recorded on the books versus those claimed for tax purposes. These differences may reveal, for example, income (credits) excluded from government contracts or contractor understatements of voluntary deletions such as for contributions or bad debts. Review of the Federal income tax return including the supplemental schedules and supporting documentation furnished to the IRS is particularly important in the audit of incurred costs since nearly all line items have contract audit application. For example, the FAR cost principles related to depreciation and

compensation costs (including pension costs) contain reasonableness and allowability criteria directly related to Federal income tax practices. The allowability of pension costs is dependent on funding and filing requirements under the tax code. The auditor should obtain explanatory comments and/or otherwise assure that costs being used as bases to develop indirect rates are consistent with or reconcilable to amounts reported as cost of goods sold and/or operations in the Federal tax return. General and administrative expenses claimed on the tax return such as salaries and wages and taxes should also be traced to the books of account and differences reconciled. Detailed reconciliation of the tax return to the books of account is not mandatory. In the event the tax return is prepared on a basis other than that of the general ledger, the reconciliation should be limited to accounts considered critical or sensitive. Guidance in determining allocable and allowable state and local income or franchise taxes is in 7-1403.

3-104.17 Use of Quantitative Methods and EDP in Contract Audits

Make optimum use of all audit techniques which will increase the efficiency and effectiveness of the audit effort. These include the use of statistical sampling, the use of improvement curves and techniques, and the evaluation of costs and accounting systems making use of electronic data processing (EDP) equipment. Suggestions for applying these techniques to various audit situations are provided throughout the manual.

a. **Statistical Sampling.** DCAA policy on the use of statistical sampling is in 4-600; guidance is in Appendix B.

b. **Electronic Data Processing (EDP).** Because of the ever increasing use of electronic data processing equipment, the auditor must become knowledgeable in the operations of such systems. Develop the audit program with due consideration to the part that EDP equipment contributes to the contractor's overall accounting system. Guidance is provided in Appendix C. Similarly, in conducting the audit, make full use of DCAA's DIIS software (wordprocessing, spreadsheet

analysis, and database management). Guidance is provided in 4-500.

c. Use of Graphic and Computational Analysis Techniques

Wherever appropriate, auditors should make full use of graphic and computational analysis techniques (Appendix E). The manual suggests instances where the auditor could productively use these techniques.

The use of graphic and computational analysis techniques can help in incurred cost audits as well as future cost estimates and is encouraged. These techniques might, for example, provide a basis for the traditional audit selectivity in reviewing accounts or cost items. That is, the auditor may detect trends or correlations which permit her or him to focus attention on indirect expense accounts or other costs being audited which appear to be unreasonable or out of line. However, the use of these techniques in the audit of incurred cost does not lessen the auditor's responsibility to obtain pertinent

evidential matter, as in 3-104.14 and to accomplish appropriate testing and verification of such data.

d. Improvement Curve Techniques.

An understanding by the auditor of improvement (learning) curve techniques (Appendix F) is essential, particularly in the evaluation of projected costs. Situations where these techniques are to be used are discussed in Chapter 9, as well as in Chapter 12 where the evaluation of a reasonable profit or loss under a terminated contract is discussed.

3-104.18 RFP/RFQ and Contract Provisions

Review of contract provisions may indicate areas of audit emphasis. For instance contracts with both fixed price and cost type provisions may require additional emphasis in floorcheck or other direct cost reviews. See 3-200 for further guidance on reviewing RFP/RFQ and contract provisions.

3-1S1 Supplement-Reports Filed by Contractors with the Securities and Exchange Commission

The Securities and Exchange Commission (SEC) is an independent government Agency created by the Securities Exchange Act of 1934. The laws administered by the SEC relate in general to the field of securities and finance, and seek to protect investors in their securities transactions. In addition to the 1934 Act, these laws include the Securities Act of 1933, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisor's Act of 1940. The SEC also advises the Federal courts in corporate reorganization proceedings under Chapter XI of the National Bankruptcy Act.

Under the 1934 Act, companies listing and registering securities on public trading exchanges are required to register with the SEC. Following registration, such companies must file annual and other periodic reports to keep information in the original filing current. These reports are for public review and should be available to the auditor at the contractor's corporate offices. The documents are also available for public inspection at the SEC Public Reference Room, 500 North Capitol Street, NW, Washington, DC 20549. Copies may also be requested for a nominal cost at that address. Additionally, current annual and other periodic reports (including financial statements) filed by companies whose securities are listed on exchanges also are available for inspection in SEC's New York, Chicago, and Los Angeles regional offices, as are the registration statements (and subsequent reports) filed by those companies whose securities are traded over-the-counter and registered under the 1964 amendments to the Exchange Act. Moreover, if the registrant's principal office is in the area served by the Atlanta, Boston, Denver, Fort Worth, or Seattle SEC regional offices, filing is required with the applicable regional office and reports may be examined there.

In practice, major government contractor registrants report in rather broad segments and large dollar amounts. As a

result, there may be differences in the type and depth of information in periodic statements filed with the SEC and statements issued directly to stockholders and the public. Accordingly, audits involving evaluation of contractor financial presentations should include a review of the latest statements filed with the SEC.

A brief summary of the various SEC reports most likely to be of interest to DCAA field units follows:

a. Form 8-K (1934 Act)-Current Report. This form is required 15 days after which any one or more of certain specified events occur. Some of the events which, if significant, require a report include (1) changes in control of registrant, (2) acquisition or disposition of assets, (3) bankruptcy or receivership, and (4) changes in registrants certifying accountant.

b. Form 10-K (1934 Act)-Annual Report. This is an annual report by companies having securities registered pursuant to the 1934 Act and companies which are required to file reports under the Securities Act of 1933. Form 10-K is to annually provide information which, together with the proxy or information statement sent to security holders, will furnish a reasonably complete and up-to-date statement of the business and operations of the registrant.

c. Form S-1 (1933 Act)-Registration Statement (of Securities). This form is used for registration under the Securities Act of 1933 of securities of all issuers for which no other form is specifically authorized or prescribed, except that the form is not used for securities of foreign governments or political subdivisions. The form includes a prospectus to inform investors. It also includes other items which are required but need not be included in the prospectus, such as expenses of issuance and distribution, indemnification of directors and officers, and recent sales of unregistered securities.

d. Form S-8 (1933 Act)-Registration of Securities to be Offered to Employees Pursuant to Certain Plans. This form is

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used for stock purchase, savings, or similar plans, and for registering the interests in such plans when required.

3-1S2 Supplement-Tax Forms Filed by Contractors with the Internal Revenue Service and State Tax Departments

State and Federal Tax returns are external reporting documents which are independently reviewed and carry substantial penalties for misstatement. As such, they provide excellent confirmation of costs claimed on contracts. Mandatory annual audit requirement No.4 on tax returns and financial statements requires the auditor to review these returns and have written confirmation of this review in the incurred cost audit files.

A brief summary of the various corporate Federal income tax return forms and schedules to be reviewed follows:

a. Form 1120 ("U.S. Corporation Income Tax Return"). Every domestic corporation not expressly exempt from tax must file an annual income tax return. A tax return is required even though there is no income or tax due and is an important source of information. Most corporations submit tax returns on Form 1120; small corporations may use Form 1120-A. Certain contract cost principles in FAR (depreciation, compensation costs, tax accruals and credits, etc.) contain reasonableness and allowability criteria directly related to the following Federal income tax schedules which are part of the Form 1120.

(1) Schedule A, "Cost of Goods Sold," provides data used in the computation of a total cost input (TCI) base and may be compared to the indirect cost rate proposal(s) if the contractor is not filing a consolidated return. The "Other Costs" section of Schedule A should be of particular interest to the auditor for unallowable costs. Schedule A also furnishes the method used for valuing closing inventory, which should be compared to permanent file data and to prior returns to identify any changes.

(2) Schedule E, "Compensation of Officers," discloses executive compensation and is separated by elements (salaries, bonuses, director's fees, etc). These compensation elements may be reviewed for reasonableness and may be compared to SEC filing (Form 10-K) for any differences.

(3) Schedule J, "Tax Computation," should be compared to prior years' returns for any possible organizational changes.

(4) Schedule L, "Balance Sheet," should be reconciled to the general ledger. Net assets should be compared to CAS 414 submissions; financial ratios should also be verified to determine and validate the "going concern" hypothesis.

(5) Schedules M-1 and M-2, "Reconciliation of Income" and "Analysis of Retained Earnings," respectively, should be reviewed for any unusual entries.

b. Form 1065 (Partnership Return). A partnership tax return on Form 1065 is required even though the firm has no taxable income for a taxable year. No tax is ever paid by a partnership; Form 1065 is an informational return. The partnership return contains data similar to Form 1120 above.

c. Form 5500, "Annual Return/Report of Employee Benefit Plans." This tax form is the basic annual reporting requirement that must be used for employee benefit plans with 100 or more participants at the beginning of the plan year. Form 5500-C is the so-called "short form" that must be used for employee benefit plans with fewer than 100 participants, none of whom is an owner-employee. This tax form, along with payroll tax return forms (940/941), should be considered in reviewing contractor pension costs.

d. Form 941, "Federal Payroll Tax Return." A contractor or employer subject to either income tax withholding or Social Security taxes, or both, must file a quarterly return. Form 941 is the quarterly return form which combines the reporting of income and FICA taxes withheld from wages, annuities, supplemental unemployment compensation benefits, third party payments of sick pay, and other sources of income. It may also be used to verify total payroll and FICA tax expense. This form should also be reviewed to disclose any possible inclusion of unallowable interest or penalties. This tax information is reliable because it can

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be reconciled to total employee salaries reported to the IRS. Also, the individual W-2 forms are reviewed by the employees. The contractor should be required to reconcile total salaries and wages to the Form 941.

e. Form 940 (Federal Unemployment Tax Return) This Federal tax form lists the actual state unemployment taxes paid. The Federal unemployment tax grants a credit for state tax payments, which are assessed by the state on the basis of historical probability that terminated employees of the contractor will

file for unemployment compensation. The review of this form can be used to verify both Federal and state unemployment taxes and may also disclose the inclusion of unallowable penalties or interest.

f. State Tax Returns - Individual state tax returns should be reviewed to determine that the amounts claimed by the contractor agree to the amounts paid, excluding penalties and interest. Only the state tax actually paid by filing date or extension thereof is allowable (FAR 31.205-41(b)(7)).

3-200 Section 2 — Briefing of Contracts and Requests for Proposals

3-201 Introduction

This section, as part of the chapter on audit planning, presents guidance on (1) briefing the provisions of contracts and requests for proposals which may affect the contract audit workload or other aspects of the FAO's work, (2) notifying contracting officers of contract provisions which may impede effective contract audit or contract administration, and (3) implementing the DoD operations security (OPSEC) program.

3-202 Auditor Review of Contract Provisions

3-202.1 Objective

Contract clauses are reviewed to determine the specific requirements for each contract to be utilized in determining allowability, allocability and reasonableness of costs billed to the government. Complete copies of contracts and contract modifications are usually available from both the contractor and government contract administrators. Contract briefs are prepared to abstract, condense, or summarize pertinent contract provisions for specific audit purposes. To facilitate repetitive reviews of contracts, briefs may be maintained in a permanent file and updated on a continuous basis as contract modifications are received, or at the time of each audit depending on the frequency and type of reviews being performed. Generally, such briefs summarize information required in progress payment reviews, interim voucher reviews, FPI closing reviews (including incentive fee computations) for fixed priced contracts and final voucher reviews, other incurred cost reviews for cost type contracts, and defective pricing reviews.

3-202.2 Auditor Reliance on Contractor Prepared Briefs

a. If the contractor's policies and procedures require contract briefs be prepared and it is cost effective to do so, review this function to determine if reliance can be placed on the contractor's

briefs (see 3-202.3 below). If reliance can be placed on the contractor's briefs, the basis for that reliance should be documented as discussed in CAM 4-1000 and placed in the permanent file, including a recommendation for the review cycle of the briefing function. The auditor will also need to analyze the contractor's internal controls for their use of this information to identify and segregate costs which are specifically unallowable under the contract provisions (see CAM 8-405). This review may be coordinated with the CAS 405 compliance review and/or the billing system review.

b. If the contractor does not brief contracts, or if reliance cannot be placed on the contractor's briefing function, the auditor should consider reporting this condition to the administrative contracting officer as an internal control deficiency. Also, if reliance cannot be so placed, the auditor will need to prepare briefs of the contracts. Special considerations in audits of selected contract types are provided in 3-2S1.

c. The FAO-prepared contract brief or the auditor's documentation of the contractor's brief will be maintained in the permanent files or audit working papers as appropriate. The briefs should be reviewed by the auditor or administrative personnel to assure that required clauses are included, and clauses that are contradictory or confusing are clarified. Examples of such provisions are discussed in 3-204.1. Audit leads for special audit analysis can also be identified at this time. Contracts which have a mixture of cost-type and fixed-price provisions may be candidates for additional emphasis in floorchecks or billing systems reviews. Likewise, contracts with extraordinary terms affecting allowability may require special emphasis during direct or indirect cost reviews or billing systems reviews.

3-202.3 Adequacy of the Contractors Briefing System

It is not appropriate to review the contractor's briefing system internal controls if it is determined that it is more economical and cost effective to have the

auditor or administrative personnel brief the contract than it is to perform the systems review. As a result, for some contractors, only portions of their system may be reviewed and utilized for audit purposes. The scope of the systems review should be based on the number and type of contracts, the materiality of the contracts, results of prior internal and external review or other self governance type activity, audit leads, the extent of automation, and the type of reviews for which they will be used. The briefing system review may be performed in conjunction with a billing system review, contract administration review, or accounting system review. Consider the following when evaluating the contractor's briefing system.

a. Training. The contractor should provide adequate training to the employees involved in the briefing of contracts. Written policies and procedures should describe the content and frequency of the training. The course should include explanations of the types of contracts, the types of FAR unallowables, the special requirements for classified contracts and the attributes of the contractor's particular system. When evaluating the adequacy of the training, the auditor may review course material, review written documentation that the employees have been trained, review personnel records to determine prior qualifications, or interview employees to determine the extent of their training. Because the same personnel may be responsible for briefings as well as the preparation of billings, review of this area may be performed simultaneously.

b. Policies and Procedures. The contractor should have policies and procedures to describe what should be included in briefs, who will prepare briefs, who will approve them, and how they will be utilized for the various purposes for which they are prepared. The contractor may prepare preprinted or computerized forms which prompt the employee for common briefing items. Contract briefings generally include a synopsis of all pertinent contract provisions, such as contract type, amount, product or services to be provided, applicable cost principles, performance period, OPSEC

measures (3-205), rate ceilings, advance approval requirements, precontract cost allowability or limitations, and billing limitations. When evaluating the briefs, the auditor should review the special considerations identified in 3-2S1 to determine adequacy. (For guidance on provisions impeding contract administration see 3-204.) The contractor may not brief all provisions of the contract, but may have alternate procedures. For example, if the contractor has adequate procedures for excluding unpaid costs from all interim vouchers, the applicable contract clause or reference to it may not be needed on the brief.

3-203 Briefing of Requests for Proposals

a. When audit review of a contractor's price proposal has been requested (see 9-100), the FAO will brief the related request for proposal (RFP) to identify requirements that may affect the review. FAR 15.805-5(c) requires the PCO to provide the applicable portions of the solicitation (RFP or request for quotations (RFQ)) with the audit request, particularly those describing requirements and delivery schedules. DFARS 215.805-5(c)(ii)(A) requires the PCO to provide the auditor with a copy of the solicitation in advance when the PCO knows that field pricing support will be required.

b. Include the auditor's briefing notes in the working papers for the proposal review assignment. If OPSEC measures (3-205) are required, promptly inform all DCAA personnel who may be affected.

3-204 Reporting on Provisions Impeding Effective Contract Audit or Administration

3-204.1 Examples of Impeding Provisions

The following are provisions of contracts or RFP/RFQs that may impede effective contract audit or contract administration and are therefore subject to special reporting:

a. Defects in or omissions of required contractual provisions, such as omission

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of contract clauses requiring contractors to maintain adequate accounting records when cost determinations are a factor or providing the government the right to audit.

b. Undesirable or ambiguous provisions, such as provisions for rate changes or price redeterminations at times or under conditions which cannot be implemented or efficiently administered.

c. Provisions which exclude portions of costs from audit review or verification, limit in any way the government's right to audit, or restrict the scope of the audit.

d. The award of a contract type incompatible with the contractor's accounting system (see FAR 16.104(h)).

e. Contracts having the characteristics of cost-plus-a-percentage-of-cost contracts, such as negotiation of contract value after contract completion.

f. Any other provisions which are not clearly stated and which may lead to subsequent misunderstanding or dispute in the audit or in the administration of the pricing provisions of the contract.

g. Provisions which are contradictory to or inconsistent with existing statutes or regulations, including Cost Accounting Standards, and/or contractor practices, such as requiring that direct contract costs be allocated to multiple contracts.

3-204.2 Reporting to the Contracting Officer

If you find provisions in a contract or RFP/RFQ that may impede effective contract audit or administration, promptly notify the contracting officer, suggesting appropriate action. You should also coordinate with the ACO to obtain clarification on contract terms that are new to you, unclear, or you have questions on intent.

3-204.3 Internal DCAA Reporting

a. Differences between the contracting officer and the auditor which cannot be resolved locally will be referred to the regional director by way of the regional audit manager. The referral will advise the regional director regarding the basis of the disagreement and the actions taken to resolve the issue. The regional director will then decide whether direct commu-

nication with the responsible procurement office is needed.

b. Where corrective action is not taken within a reasonable time and where the issue involved is deemed to have policy impact or may have a significant monetary impact, the regional director will submit a report to Headquarters, Attention PFD, containing the following information:

(1) Summary of the situation and actions taken by the regional director.

(2) Summary of discussions with the contracting officer.

(3) Any other pertinent information.

(4) The regional director's recommendations.

c. Headquarters will advise the regional director of the actions taken on each case and the final resolution of the problem area.

3-205 DCAA Implementation of the DoD Operations Security (OPSEC) Program

a. The DoD OPSEC program, policy, and responsibilities are contained in DoD Directive 5205.2. The OPSEC program applies to DoD contractors participating in the DoD Industrial Security Program when such measures have been determined essential for the adequate protection of classified information with respect to a specific classified contract. The Head of the responsible DoD Component makes the determination as to the applicability of the OPSEC program requirements to the contract. Thus, the OPSEC program ensures the protection of DoD programs, operations, and activities by maintaining essential secrecy through the protection of classified materials and information. The guidance which follows constitutes DCAA's implementation of DoD Directive 5205.2.

b. Normally, FAOs will not need to have direct access to information in the DoD Directive; however, a copy may be obtained from a DoD publications distribution office if further information is desired. When briefing any classified contract or RFP/RFQ, carefully note any OPSEC measures required of the contractor. Required OPSEC measures may

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have an impact on the contractor's pricing and costing of a contract. Also, DCAA personnel must comply with any OPSEC measures required by a contract

or RFP/RFQ. Direct questions concerning OPSEC measures to either the regional security officer or contract administration officials.

3-2S1 Supplement Special Considerations in Audits of Selected Contract Types

<u>Cost Reimbursible Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
1. FAR Citations		
FAR 52.216-7, 52.216-13, 52.216-14 general requirements.	FAR 52.232-7	FAR 52.232-16, 32.5, 42.7
<u>Accrued Versus Paid Cost</u> Billed costs do not include accrued costs (not paid) for items or services purchased directly for the contract.	Same as cost reimbursible.	Same as cost reimbursible.
<u>For purposes of interim reimbursement.</u> Allowable costs include recorded costs of items or services purchased directly for the contract for which the contractor has paid (small business concern may bill these costs even though the concern has not yet paid for them) and costs incurred, but not necessarily paid for materials issued from the inventory and placed into production, direct labor, direct travel, other direct in-house costs, allowable and allocable indirect costs, and progress payments or interim vouchers paid to subcontractors.	Same as cost reimbursible for the ODC or material portions of the contract. Labor, applicable burden and profit is billed at a category rate applicable to actual hours or man days, etc.	Same as cost reimbursible.
<u>For final vouchers.</u> Allowable costs include all paid costs, including reimbursible subcontracts and interdivisional transactions which must have been closed out and for which required final audits have been performed.	Same as cost reimbursible for the ODC or material portions of the contract. Labor, applicable burden and profit is billed at a category rate applicable to actual hours or man days, etc.	The allowable amount is the excess of the contract price over the amount required to liquidate progress payments.
<u>Delinquent Payments</u> <u>For interim vouchers.</u> Billed costs do not include accrued costs that the contractor is delinquent in paying for in the ordinary course of business.	Same as cost reimbursible for the ODC and material portions of the contract.	Same as cost reimbursible.
<u>Unallowable Cost</u> Billed costs do not include unallowable costs.	Same as cost reimbursible for the ODC and material portions of the contract	Same as cost reimbursible.
<u>Pensions, etc.</u> Billed costs do not include accrued costs of pensions, post retirement		

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<u>Cost Reimbursible Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
benefits, profit-sharing or employee stock ownership plans that have not been paid at least quarterly (within 30 days after the end of the quarter).	Same as cost reimbursible for the ODC and material portions of the contract.	Same as cost reimbursible.
2. Ceiling or Funding Limitations		
Cost type contracts may set ceilings on indirect rates, on specific elements, and on contract line items. These ceilings may apply on an interim or interim and final basis. The contractor cannot be reimbursed for costs in excess of the identified ceiling.	Same as cost reimbursible.	Not Applicable.
The contract will provide funding limitation amounts which are less than the contract value until the contract fully funded. These limitations are not to be exceeded on an interim basis and on a final basis the contract should not claim costs in excess of the estimated total amount stipulated in the contract.	Same as cost reimbursible.	Same as cost reimbursible.
See also 11-100 for guidance on the limitation of cost clause.	Not applicable.	See also 11-100 for guidance on the Limitation of Payments Clause. Progress Payment and Liquidation rates are specified in the contract.
3. Cost Sharing Arrangements		
Contracts may identify percentages or absolute values in excess of which the government will not reimburse costs.	Not applicable.	Not applicable.
4. Retentions and Withholds		
<u>Patent Rights and Technical Data Withholds.</u> The contract may provide for temporary withholding of amounts as reserves from payments otherwise due to the contractor, to assure performance of certain contractual requirements. FAR 27.305-3(3) provides that if the contractor fails to furnish certain reports relative to	Not Applicable.	Not Applicable.

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
<p>inventions developed by the contractor under the contract, the contracting officer may invoke the withholding of payments provision of the patent rights clause which states that the government may withhold payment until a reserve not exceeding \$50,000, or 5 percent of the amount of the contract, whichever is less has been set aside. Similarly, the clause in DFARS 227.473-5 provides for withholding of 10 percent of the allowable costs and fixed fee from payment on an interim basis when the contractor does not deliver certain technical data required by the provisions of the contract.</p> <p><u>Fee Withholds.</u> For payments of the fixed fee under cost-reimbursement contracts, FAR 52.216-8(b), 52.216-9(c) and 52.216-10(c) all provide for the withholding of the fee on an interim basis after payment of 85 percent of the fixed fee until a reserve is set aside in an amount that the contracting officer considers necessary to protect the government's interest. The reserve will be from 0-15 percent of the total fixed fee or \$100,000, whichever is less. Based on the contract terms, the percent will be specified or determined at the discretion of the contracting officer.</p> <p>Not Applicable.</p>	<p>Not Applicable.</p> <p><u>Hours Withhold.</u> FAR 52.232-7(a)(2) states that unless otherwise prescribed in the Schedule, the contracting officer shall withhold 5 percent of the billable hours, not to exceed a total of \$50,000 for the entire contract. The withholding will apply to the billable hour portion only, and not to direct material or subcontract amounts. The same provision for time-and-materials contracts also applies to indefinite-</p>	<p>Not Applicable.</p> <p>Not applicable.</p>

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
	delivery-type contracts which may be identified by a "D" in the ninth position of the Procurement Instrument Identification Number (contract number).	
5. Required Frequency of Billing		
Interim vouchers and final vouchers on completed or terminated contracts and subcontracts are submitted for payment on time intervals provided for by the contract for both negative and positive billings. The contractor may have threshold criteria that must be met in order to bill besides the time intervals provided below, such as a dollar value threshold. Gain an understanding of the reasons for these other thresholds.		
<u>Interim Vouchers.</u> The contractor may submit an interim invoice or voucher as work progresses (but generally not more often than once every two weeks for large contractors) in amounts supported by a statement of the claimed allowable costs for the period.	Vouchers may be submitted only once a month, unless otherwise approved by the contracting officer.	Vouchers may be submitted only once a month.
<u>Final vouchers on completed contracts.</u> Completion vouchers should be submitted promptly upon completion of the work, but no later than one year (or longer, as the contracting officer may approve in writing) from the completion date per FAR 52.216-7(h)(1). Care should be taken that final or quick close-out rates (6-1009) are determined, and subcontract or inter-divisional transactions have been properly closed out.	Same as cost reimbursible.	Final invoices are submitted as items are delivered.
<u>Final vouchers on terminated contracts.</u> On terminated contracts the final voucher may be submitted at the end of the vouchering out period (12-402) or after completion of the termination negotiations.	Same as cost reimbursible	Not applicable.
6. Profit or Fee		

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
Fees may be of the fixed, award or incentive type. Contract types and computational methodology are discussed in detail in FAR Part 16 and DLAM Fees may be billed with cost or may be separately vouchered.	These contracts provide for billing direct labor at predetermined category rates which include all applicable burden and profit, and billing other direct costs (ODCs) and direct materials on T&M contracts at cost plus applicable burden (no profit).	Profit may be fixed or incentive or the contract may require economic price adjustments. Contract types and computational methodology are discussed in detail in FAR Part 16 and DLAM.
For interim payments. The contract terms specify how the fee will be computed on an interim basis. Generally, fee is billed as a percentage of incurred cost until it meets any funding or withhold limitations. (Fee withholds are explained in 3 above.) However, Award fees are generally the subject of a special contract modification and the specific amount to be billed is given.	Profit is billed as part of the rate.	Contract line items are billed at price unless progress payments or advance payments are allowed.
For final vouchers. The fee is calculated in accordance with the terms of the contract.	Profit is billed as part of the rate.	Contract line items are billed at price less any credit for liquidating progress payments.
7. Forms and Documentation Requirements		
The submission form (SF 1034) is approved by the auditor or contracting officer. Detailed information concerning the preparation, submission and processing of these forms is presented in DCAAP 7641.90. This pamphlet is available for distribution to contractors.	Same as cost reimbursable.	For progress payments the SF 1443 is used. Instructions for the SF 1443 are on the back of the form.
The contract generally identifies the cognizant DCAA office responsible for processing vouchers.	Same as cost reimbursable.	Not applicable.
Special submission forms or data may also be identified at the same time. COTRs (Contracting Officers Technical Representative) may be identified and documentation and		

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<u>Cost Reimbursible Contracts</u>	<u>T&M and Labor Hour Contracts</u>	<u>Fixed Price Contracts</u>
voucher routing requirements specified for their approval of work performed.		
8. Performance Period.		
A contract may provide that it expires on a specified date, unless terminated before that date, and obligates the contractor to devote a specified level of effort for a stated time period (FAR 16.306(D)(2) and FAR 52.249-6(a)). The auditor shall not approve for reimbursement any costs incurred by the contractor subsequent to the expiration date stated in the contract, or in excess of contract limitations.	Same as cost reimbursible.	A fixed price contract requires specific delivery dates for item. Missing these dates may result in penalties.
9. Specified Completion or Delivered Product.		
A completion or delivered product specified in a cost-type contract normally commits the contractor to complete and deliver the specified product within the estimated cost. In the event the work cannot be completed within the estimated cost, the government may require more effort without an increase in fee (FAR 16.306(d)(1)). Also, under FAR 52.246-6(a), the contracting officer could terminate the contract prior to full expenditure of the estimated cost. However, unless the contract is terminated, or exceeds stated contract limitations, the contractor is normally obligated to continue to perform under the contract up to the estimated total contract cost.	Not Applicable.	Not Applicable.
10. Other Provisions		
Overtime Premium Overtime premium is probably the most frequently limited cost and is generally identified in the contract's FAR clauses section, FAR 52.222-2. The clause identifies an amount from \$0 upward in excess of which the contractor can not bill.	The contract may provide a category rate to be applied to overtime hours, the contract may specify the number of hours allowable, it may specify the type of work or type item it is allowable on, or who will approve it.	Not Applicable.
Other Other contract provisions are generally identified in the H-		

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Fixed Price Contracts

section of the contract. They may include allowance criteria or conditions (cost ceilings or time frames) for certain costs such as precontract costs (also see FAR 31.205-32), costs incurred after the completion or delivery date specified in the contract, or costs incurred in excess of the contract amount.

First Article Approval Not
Applicable.

Not Applicable.

A fixed price contract may require first article approval (FAR 52.209-3 or -4) before the contract is eligible for progress payments.

3-300 Section 3 - Internal Control Assessment Planning Summary (ICAPS)**3-301 Introduction**

This section provides guidance on using the Internal Control Audit Planning Summary (ICAPS) to summarize the auditor's assessment of control risk and the impact on related contract audit effort. For guidance on performing reviews of contractor accounting and management systems, and related internal controls, see CAM Chapter 5.

3-302 Background Information

a. As discussed in CAM 3-100, the auditor's assessment of control risk is a critical factor in determining the nature and extent of audit effort necessary to achieve the objectives of the individual audit assignment in an effective and efficient manner. To assess control risk, the auditor must carefully evaluate the controls over each significant contractor accounting and management system which could impact the scope of that particular audit. Due to the number of contract audits performed at some contractors, it is both impractical and inefficient to duplicate all the audit steps necessary to assess control risk as part of each individual audit assignment. Therefore, separate audit assignments are established to review and evaluate each significant contractor accounting and management system and the related controls on a periodic basis. The resulting control risk assessments are summarized on the Internal Control Audit Planning Summary working paper along with a brief description of how these assessments may impact the scope of other related contract audit effort.

b. The Internal Control Audit Planning Summary becomes part of the FAO's permanent file and can be used by other auditors to quickly understand the level of control risk associated with the contractor's accounting and management systems and the potential impact on their individual audit assignments. For example, an auditor performing a progress payment audit can review the Internal

(ICAPS) for the contractor's billing system and immediately determine the assessed level of control risk and how it could impact his review.

3-302.1 Relationship of ICAPS and Mandatory Annual Audit Requirements (MAARs)

a. A general discussion of MAARs appears in 6-100; a tabulation of the MAARs, including title, classification, objectives, purpose, and principle CAM reference, appears in 6-1S1.

b. Transaction test and special purpose MAARs are most likely to be covered during incurred cost audit assignments. The scope of such reviews is affected by the strength of the contractor's internal controls and the currency of audit experience in the area. Internal controls affecting the MAARs are summarized in the Internal Control Audit Planning Summary (ICAPS) for each related contractor accounting and management system. For example, internal controls affecting MAAR 6, Labor Floorchecks or Interviews, are summarized in the Internal Control Audit Planning Summary for the contractor's labor accounting system. It is often possible to reduce the scope of a mandatory review when the contractor's internal controls in the area are strong. Conversely, it may be necessary to expand the scope of a mandatory review to cover audit risks identified in the Internal Control Audit Planning Summary. However, the focus of the auditor's efforts should be to work with the contractor and ACO to reduce risk ratings rather than to continue performing expanded testing.

3-303 General Audit Policy

a. A separate Internal Control Audit Planning Summary will be maintained for each of the ten management and accounting systems, identified in CAM 5-102. However, we are only concerned with assessing control risk for those systems that process a material amount of transactions that are ultimately assigned to government contracts. The Internal

3-303a.

Control Audit Planning Summary form is the summary audit working paper for the audit of the system and related internal controls. Copies of the forms should also be retained in the permanent file.

b. Significant information contained in the Planning Summary, either positive or negative, should be communicated to the appropriate auditors immediately (e.g., risk information on the Planning Summary for the estimating system, should be communicated to auditors performing reviews of individual proposals).

c. Since the Internal Control Audit Planning Summary is intended to support the audit planning process, each Internal Control Audit Planning Summary form should contain sufficient information to help plan other related contract audit activities. While the following paragraphs provide general guidance on completing the Internal Control Audit Planning Summary form, auditors should exercise professional judgment in determining the exact nature and extent of information necessary in their individual audit circumstances.

3-304 Preparation of the Internal Control Audit Planning Summary

Figure 3-3-1 contains a generic copy of the Internal Control Audit Planning Summary form. The specific ICAPS for each of the ten systems are available on the DIIS. As discussed above, a separate Internal Control Audit Planning Summary form should be maintained for each contractor accounting and management system. The Internal Control Audit Planning Summary form is updated during the normal cyclical audit of each significant system and related internal controls (e.g., during the estimating system survey).

3-304.1 Materiality and Sensitivity

As discussed above, DCAA is only concerned with assessing the adequacy of internal controls for those contractor accounting and management systems which may have a significant impact on the pricing, administration, or settlement of government contracts. This section of the Internal Control Audit Planning Summary provides information concern-

ing the significance of each system for each Contractor Fiscal Year (CFY). In addition, it provides a brief summary of any sensitivities which may impact other related audit effort.

a. Materiality is determined based on the importance of the contractor accounting or management system relative to government contracts. While all major contractors generally accomplish the functions associated with the ten accounting and management systems identified in CAM 5-102, the materiality/significance of these systems will vary from contractor to contractor. Therefore, it is important for the auditor to understand the dollar value of transactions processed by the system and assigned to government contracts, both flexible and fixed price, and their significance in relation to (1) the total dollar value of transactions processed by the system, (2) total government contract costs, and (3) total contractor operations. To illustrate, the auditor's determination of materiality for a contractor's labor system should consider the total dollar value (order of magnitude) of labor transactions (\$100 million) processed by the system in relation to the order of magnitude for contractor's total operation \$1 billion cost of sales. The auditor should also consider the government's participation, both flexible and fixed price, in the system's transactions, as well as within the contractor's total operations.

	System	Contractor
Total Dollars	\$100 million	\$1,000 million
Gov't Flexibly Priced Dollars	\$ 20 million	\$ 80 million
Gov't Fixed Price Dollars	\$ 25 million	\$ 170 million

b. Sensitivity is determined based on how given matters will impact the judgments of the users of contract information. For example, inclusion of some unallowable costs (e.g., luxury yachts, dog kennels) have a more significant impact on users of contract information than clerical errors or inadvertent mistakes. In addition, some costs may be more sensitive than others due to congressional interest or other external factors. One

such example was the emphasis placed on consultant costs during the late nineteen eighties. Section I.2 of the Internal Control Audit Planning Summary is designed to summarize any unusual or unique sensitivities applicable to the system in question.

c. The auditor should carefully consider the system materiality and sensitivity in determining the timing, nature and extent of system review effort. If a particular system is not considered material for the current year, there is no need to assess control risk further. The basis for this assessment should be documented on the Internal Control Audit Planning Summary working paper and filed in the permanent files for reference and review/update in future years.

3-304.2 Control Risk Assessment

This section of the Internal Control Audit Planning Summary is designed to summarize the auditor's assessment of control risk for each relevant control objective. CAM 5-109 contains detailed guidance on assessing control risk.

a. The auditor should first identify each of the relevant control objectives for the system being summarized. CAM sections 5-300 through 5-1200 contain details regarding the relevant control objectives for each contractor accounting and management system. For example, the relevant control objectives for labor accounting are covered in CAM 5-900 and are summarized as follows:

- (1) Management Reviews
- (2) Employee Awareness Training
- (3) Labor Authorization and Approvals
- (4) Timekeeping
- (5) Labor Distribution
- (6) Labor Cost Accounting
- (7) Payroll Preparation and Payment
- (8) Labor Transfers and Adjustments

b. For each relevant control objective, the auditor should summarize the control risk assessment (low, moderate, or high) contained in the detailed working papers.

c. The auditor should also indicate the report number and date in which the control risk assessment for any control objective was most recently updated. As more current information becomes available, the auditor's assessment of control risk may change. For example, the con-

tractor may correct a previously reported deficiency or subsequent audit effort may indicate failures to comply with established policies and procedures. In these instances, the auditor should update the Internal Control Audit Planning Summary upon issuance of the audit report which resulted in the change in control risk assessment. Under no circumstances should the Internal Control Audit Planning Summary be updated for potential changes in the control risk assessment which have not been formally reported.

d. The last section of the control risk assessment requires the auditor to explain all moderate or high risk assessment ratings. Ratings of moderate or high risk should be supported by significant reported deficiencies, and the explanations should briefly describe the nature of the reported deficiencies which resulted in the moderate or high control risk assessment. The auditor's explanation should be as concise as possible but provide sufficient information to facilitate the planning of other related audit effort.

3-304.3 Overall System

a. In addition to assessing control risk for each of the relevant control objectives, the auditor should determine whether the system is adequate to reasonably assure proper pricing, administration, and settlement of government contracts. Making such a determination requires the exercise of considerable audit judgment. In some instances, the contractor's failure to accomplish a single control objective may render the entire system inadequate.

b. The auditor's assessment of the overall system should be consistent with the audit opinion contained in the most current report on the system in question and with the risk ratings assigned to the relevant control objectives. For example, in the case of the labor system review, if high risk ratings have been assigned to labor cost accounting and labor transfers and adjustments, it would be expected that the overall system opinion would be inadequate or inadequate in part.

3-304.4 Impact on the Scope of Other Audits

a. The audit planning process involves not only assessing control risk but also

identifying the potential impact of these risk assessments on other related audit effort. Section IV of the Internal Control Audit Planning Summary is designed to highlight the impact that the auditor's control risk assessment has on related audit areas. These audit areas are summarized as follows:

- (1) Contract Pricing
- (2) Defective Pricing
- (3) Incurred Material Costs
- (4) Incurred Labor Costs
- (5) Incurred Indirect/ODC Costs
- (6) Contract Reporting
- (7) Billings
- (8) Closeouts

b. The impact on audit scope should also identify the specific area(s) of scope impacted. For example, if a review of the contractor's estimating system indicates that the contractor does not perform sufficient cost/price analysis of subcontract proposals, the auditor may indicate a need to increase the scope of contract pricing and defective pricing reviews in the area of subcontracts. Generally, assessments of low risk should result in recommended reductions in the scope of related audits, unless the scope has previously been appropriately reduced, which should be documented and explained. This section of the Internal Control Audit Planning Summary should also be used to communicate any additional information considered necessary to ensure proper consideration of control risk assessments in related audit effort.

3-305 Internal Control Audit Planning Summary Updates and Revisions

a. Since contractor internal controls are reviewed on a cyclical basis, it may

become necessary to update the auditor's assessment of control risk prior to the next scheduled system review. For example, audits of individual pricing proposals may identify deficiencies in the contractor's estimating system which did not exist or were not identified at the time of the last system review. In these instances, the Internal Control Audit Planning Summary should be updated to reflect any changes in the auditor's assessment of control risk or the impact on other related audit effort. Any changes to the Internal Control Audit Planning Summary should be based on reported conditions. Prior versions of the Internal Control Audit Planning Summary should be retained for reference.

b. Auditors should also be alert for factors which may indicate that the current control risk assessment may be invalid. These factors may include (1) material amounts of questioned cost in individual audit assignments, (2) recurring questioned costs of an immaterial amount, (3) significant turnover in contractor personnel, (4) contractor reorganizations, and (5) other risk factors. In these instances, it may be necessary to increase the scope of related audit effort. However, the auditor should also consider performing an updated or supplemental internal control review to reevaluate the contractor's internal controls and encourage contractor corrective action for any identified deficiencies. Getting the contractor to correct the system is generally a more effective and efficient way to protect the government's interest in the long run. Changes in the assessed level of control risk, both positive or negative, should be based only on reported conditions.

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Figure 3-3-1

Figure 3-3-1

Assign. No. _____
Report Date _____

DEFENSE CONTRACT AUDIT AGENCY
INTERNAL CONTROL AUDIT PLANNING SUMMARY
FOR THE _____ SYSTEM OF

(Contractor Name)

I. MATERIALITY AND SENSITIVITY

1. Materiality (For CFY Ending: _____)

	<u>System</u>	<u>Contractor</u>
Total Dollars	_____	_____
Gov't Flexibly Priced Dollars	_____	_____
Gov't Fixed Priced Dollars	_____	_____

2. Sensitivity

II. CONTROL RISK ASSESSMENT

<u>Control Objectives</u>	<u>Control Risk</u> (System: Adequate/Inadequate)			<u>Updates Since</u> <u>Last Review</u>
	<u>Low</u>	<u>Mod</u>	<u>High</u>	<u>Report No./Date</u>
1.				
2.				
3.				

Briefly explain the reported system deficiencies which support all moderate or high control risk assessments:

III. OVERALL SYSTEM

Adequate _____ Inadequate: _____ Overall
In Part _____

IV. IMPACT ON THE SCOPE OF OTHER AUDITS

<u>Audit Areas</u>	<u>Impact on</u> <u>Audit Scope</u>			<u>Area of Scope Adjustment</u>
	<u>Decr</u>	<u>N/C</u>	<u>Incr</u>	
Contract Pricing				
Defective Pricing				
Incurred Material Costs				
Incurred Labor Costs				
Incurred Indirect/ODC Costs				
Contract Reporting				
Billings				
Closeouts				
Other _____				

Initials/Date:

Auditor: _____
Supervisor: _____
FAO Manager: _____

3-400 Section 4 - Workpackage Risk Analysis Procedure (WRAP)

3-401 Introduction

This section deals with the use of WRAP to (1) select among alternative workpackages within a mandatory audit area and (2) prioritize discretionary workpackages covering operations audits, systems reviews and historical audits of incurred costs.

3-402 WRAP Defined

a. WRAP is an optional decision modeling technique applied to select workpackages for inclusion in the requirements and program plan. WRAP inputs are (1) the estimated minimum hours required to perform a review of a specified workpackage when no basis for expanding the review is identified, and the savings, if any, likely to result from this review; (2) the estimated additional hours required to expand the review if questioned cost or cost avoidance is identified, and the estimated maximum dollar value of the cost savings which might result from the review; and (3) any intermediate values of hours and dollars which the planner believes to be appropriate. WRAP generates expected hours to perform the review and an index number which approximates the expected savings per hour which will result if a workpackage is performed. The WRAP index may be thought of as the relative risk associated with failure to perform a given workpackage within a specified group.

b. WRAP is used in planning incurred cost audits when the planner wishes to quantify the decision making process, either to select among alternatives or to support a decision to limit or expand sample size. It is applied at the workpackage level.

3-403 WRAP Procedure

The steps for computing the WRAP index of an individual workpackage follow:

a. Estimate the dollars which will be analyzed under each workpackage at the contractor location. The estimates need

not be precise. Note that there will be some overlapping of dollars analyzed between workpackages within an audit area.

b. Estimate the maximum percent of the dollars analyzed which might be questioned or cost avoidance which might be realized by an audit of the scope prescribed by the workpackage at the location. Workpackages may be combined for estimation of dollars analyzed and maximum savings of a larger package.

c. Calculate or identify:

(1) The minimum savings likely to result from performance of the workpackage. This will often, but not always, be zero.

(2) As many intermediate values of potential savings as seem desirable, based on the planner's familiarity with the area.

(3) The dollar value of the maximum estimated savings (dollars in the workpackage X estimated percent; 3-403a X 3-403b).

d. Estimate:

(1) The hours required for a review of the workpackage area which is adequate to rule out the possibility of significant findings and justify terminating the audit, whether by projecting results from a statistically valid sample or by terminating the review without findings. Associate this with the minimum savings identified in 3-403c(1).

(2) The hours associated with each selected intermediate value of savings (3-403c(2)).

(3) The hours associated with the maximum findings calculated in 3-403c(3). This will usually be the maximum effort the planner is willing to expend on an area without referring the findings to a higher level for authority to proceed.

e. Tabulate the estimated savings amounts and their associated hours as shown in columns (1) and (2) of Figure 3-4-1.

f. Assign a probability to each potential outcome. The probabilities must add to 100 percent as shown in Column (3) of Figure 3-4-1. Estimated probabilities quantify the planner's knowledge of such

variables as: the inherent vulnerability of the underlying transactions at any location; the controls in effect at this location; the skills of available staff; and any other factors which bear upon expected audit outcome in a given workpackage.

g. Multiply each outcome's probability by:

(1) Estimated savings; enter in column (4).

(2) Estimated hours; enter in column (5).

h. Sum the products of probability and savings for each potential audit outcome of this workpackage. The resultant amount is referred to as expected savings and represents the most likely cost recovery.

i. Sum the products of probability and hours for each potential audit outcome of this workpackage. The resultant quantity is referred to as expected hours and represents the hours which should be budgeted if the package is programmed.

j. Divide the expected savings by the expected hours. This is the WRAP index

used for ranking discretionary and semi-discretionary workpackages, sometimes referred to as expected savings per hour.

3-404 Use of the WRAP Index

a. WRAP scores are first used to select the workpackage to be performed in a mandatory area. Remaining workpackages are prioritized in descending order of their respective WRAP index.

b. Several workpackages may be selected for accomplishment within a single audit area. Because the computation of estimated savings is based on dollars analyzed, there may be some overlapping of estimated savings between workpackages within an audit area. To avoid duplication of planned effort, WRAP rankings must be reviewed for redundancy before the final listing is input to the annual requirements plan.

c. Because WRAP rankings are highly location-specific, WRAP applies only to the ranking of incurred cost audits within a single contractor location.

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Figure 3-4-1 (Ref. 3-403)
Example of WRAP Index Computation

Workpackage Data	(1) Estimated Savings (000)	(2) Estimated Hours	(3) Estimated Probability	(4) Expected Savings (1)X(3)	(5) Expected Hours (2)X(3)	(6) Expected Savings/Hour (4)/(5)
Workpackage No. 10544*						
Travel - Operations Audit	\$ 0	40	50%	\$ 0	20	
Total Dollars = \$2 million	200	60	30	60	18	
Auditable Dollars = \$1.5 M	225	65	20	45	13	
Maximum Savings = 15 percent			100%	\$ 105	51	
Total						2.06
WRAP Index (Savings/Hour)						
Workpackage No.16600*						
Direct & Indirect Travel	\$ 30	20	10%	\$ 3.0	2	
Total Dollars = \$2 million	45	30	40	18.0	12	
Auditable Dollars = \$1.5 M	60	40	40	24.0	16	
Maximum Savings = 5 percent	75	50	10	7.5	5	
Total			100%	\$ 52.5	35	
WRAP Index (Savings/Hour)						1.50
Workpackage No.14400**						
Indirect Travel	\$ 25	24	50%	\$ 12.5	12	
Total Dollars = \$400,000	75	24	50	37.5	12	

Auditable Dollars = \$300,000			
Maximum Savings = 25 percent			
Total	100%	\$ 50.0	24
WRAP Index (Savings/Hour)			2.08
Workpackage No. 12150***			0.00
Direct Travel			
			Not WRAPped

* No. 10544 vs. No. 16600: If an audit of travel must be scheduled because of an audit lead, the operations audit would be scheduled. If travel were merely one of a number of discretionary assignments, it would be scheduled only if its WRAP index, 2.06 or an estimated \$2,060 cost savings per hour, exceeded the program plan threshold. In neither case would the historical audit be scheduled. It must be deleted from the schedule of discretionary assignments because the underlying auditable dollars either are covered in a mandatory assignment or may be covered in a higher-ranked discretionary assignment.

** No. 14400: Note that if the audit lead had suggested that the maximum savings under the historical audit were expected to arise exclusively from a 100 percent review of \$400,000 total or \$300,000 auditable executive travel which could be accomplished in 24 hours, the WRAP index for this review would be 2.08 and it would be scheduled. If the operations audit is to remain in the discretionary assignments listing, the auditable dollars and estimated hours must be reduced to eliminate the overlap.

*** No. 12150: Direct travel has not been WRAPped because under the described conditions the planner does not expect measurable savings from such a review. Total and auditable dollars in the final WRAP analysis should always be less than totals incurred because (1) the bulk of the dollars will be covered in mandatory assignments not subject to WRAP and (2) some dollars will have been incurred in areas which are known to have both low risk and low potential savings.

3-S10 Supplement — Illustrations of Contract Audit Disclosures

3-S101 Introduction

a. This chapter has presented general concepts for contract audit planning. Following these concepts will result in more effective audit and, thus, more effective reporting. Some examples of contract audit disclosures resulting from use of these concepts are in this supplement.

b. In an actual audit report, the presentations would, of course, be expanded to provide the necessary details. The illustrations have been arranged according to principal areas of contract audit attention.

3-S102 Contract Audit Disclosures on Contractors' Contract Financial Management

3-S102.1 Forecasting of Cost Underruns or Overruns

Review of a major missile contractor's procedures and practices related to its preparation of contract financial management reports (Form 1097) to the government under various cost-reimbursement type contracts indicated that significant contract cost information available to the contractor's management was not being considered in preparing its reports, since few if any underruns had been reported. An audit report covering this matter was sent to the contracting officer with appropriate recommendations. The contractor revised its procedures and shortly thereafter reported a projected \$20 million cost underrun on one of its major contracts.

3-S102.2 Monitoring Physical Progress Versus Cost Performance

The contractor's cost under a major weapons systems contract exceeded the contract target cost even though only 50 percent of the milestones established under the contract had been accomplished. These milestones are significant events in a work package. There had been no previous indication of this adverse condition. The contractor acknowledged the weaknesses in its contract financial man-

agement procedures and installed revised procedures to provide better information and management control over physical performance of major segments of the contract task in relation to contract funds.

3-S102.3 Equity in Managing Commercial Versus Government Work

A large weapon systems contractor followed a policy of renting space for all its government work, but performed commercial work in contractor-owned plants where occupancy costs per square foot were substantially lower. This difference in management policy for obtaining physical plant requirements produced an obvious costing inequity for government contract work. In order to obtain a more equitable allocation of indirect costs, the auditor recommended use of a single rate for distributing occupancy costs to all plants of the contractor. The contractor concurred in this recommendation and as a result the indirect costs allocated to government contracts were reduced by approximately \$1 million per year.

3-S102.4 Funding of Self-Insurance

A contractor claimed reimbursement from the government for cost of an unfunded self-insurance program for payment of employees' death benefits. The auditor determined that the annual charges for the program were higher than necessary because the contractor did not irrevocably fund the amounts charged as cost and invest them. The program was thus deprived of income from investments. After discussion with the contractor, an irrevocable trust was established with annual savings of \$700 thousand derived from income earned by the trust fund.

3-S103 Contract Audit Disclosures on Contractors' Preparation of Price Proposals

3-S103.1 Using Historical Data for Projections

A subcontractor's proposal included estimated direct labor costs computed by

use of learning curves. However, the subcontractor used, as a projection base, the unit hours initially quoted on previous job estimates. The auditor disagreed with projecting previously quoted hours for identical work when historical hours were available and accordingly projected learning curves using historical hours as the base. In negotiation, the proposal was reduced 16 percent, most of which was attributed to the more realistic projection resulting from use of historical data.

3-S103.2 Establishing Proposal Procedures and Controls

At one sole source major contractor, the auditor examined cost proposals during a fiscal year, totaling \$188 million, and questioned more than \$53 million as overestimated costs. In negotiation, substantially all of this was reflected in reduced contract prices. The auditor recommended that the contractor establish policies and procedures to provide for (1) uniform guidance for the preparation and support of cost proposals, (2) the compilation of a complete estimating data package for each contract, and (3) managerial review of proposal estimates prior to their submission. At the insistence of the contracting officer, improvements were made which reduced the amount of necessary audit surveillance of proposals.

3-S104 Contract Audit Disclosures on Contractors' Make-or-Buy Decisions

3-S104.1 Effective Use of Make-or-Buy Committee

A contractor's make-or-buy procedure had been approved as representing an effective framework for conduct of activities in this area. It was found that during a 2-year period, 305 contract cost proposals involving many complex components were prepared, but only 12 make-or-buy committee decisions were made. The shifting of in-house work to other plants of the contractor, possibly at higher costs, was also reported as requiring closer review and appraisal under the established make-or-buy criteria.

3-S104.2 Lack of Make-or-Buy Review

During an audit of a repricing proposal for a contract, the auditor determined that a certain part made by the contractor under that contract as being purchased under a different contract at \$155 thousand less than the "make" costs proposed for the contract price being audited. No make-or-buy decision had been made for this part, although it should have been so considered under the contractor's policy. In this instance, based on the auditor's information, the contracting officer excluded a major portion of the excess cost in the repricing of the contract.

3-S105 Contract Audit Disclosures on Contractors' Purchasing and Subcontracting Practices

3-S105.1 Pyramiding of Profits on Subcontracts

A major missile prime contractor sold noncompetitive proprietary products to one of its subcontractors at a selling price of about \$2 million including profit. The subcontractor used the products in its own production, which was sold at a profit to the prime contractor. The prime contractor's repricing proposal for the contract included computed profit on all subcontract costs, including the proprietary items mentioned above. The audit disclosed that these transactions resulted in increased costs to the government of \$630 thousand due to the pyramiding of profit. This condition was explained in the audit report with a recommendation that the excessive profit be eliminated in negotiating the repricing proposal, and that in the future, similar items should be furnished by the prime contractor to its subcontractor at no charge. In negotiation, the contracting officer obtained a reduction in the contract price of about \$600 thousand based on this recommendation.

3-S105.2 Developing Alternate Sources

An audit report contained details of a continuing high incidence of sole source procurement by the contractor. Implementation of the report recommendations ultimately led to the establishment of an alternate-source program and re-

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sulted in the establishment of new sources of supply. In some instances quoted prices from the new sources were 25 percent lower than the unit prices of original sole source suppliers, resulting in a savings to the government estimated at \$800 thousand.

3-S105.3 Pricing of Sole Source Repair Parts

At a major aircraft manufacturer, the auditors, in conjunction with government technical representatives, determined that the prices charged by a sole source supplier for certain repair parts appeared to be unreasonable. Arrangements were then made through the prime contractor for an audit to determine whether the parts were, in fact, overpriced. The parts supplier delayed the government audit, pending its own study, and subsequently refunded \$581 thousand to the prime contractor, prior to making any cost data available to the auditor.

3-S105.4 Savings Through Government-Furnished Parts

At the start of a major weapon system program, certain parts had been furnished by the government to the contractor. Subsequently, in connection with the solicitation of a follow-on procurement, the parts were designated to be furnished by the contractor. When the auditor disclosed in the initial pricing report that this practice would increase costs substantially, the procurement agency reverted to the previous practice and arrangements were again made to contract directly for required quantities of these items. Contract terms were appropriately revised and savings of over \$500 thousand were realized.

3-S105.5 Forecasting Material Shrinkage Requirements

A contractor's estimating and record keeping practices were found to be insufficient for the determination of the percentage allowance for material losses. The weaknesses consisted of the lack of timely, accurate, and complete recording of incurred shrinkage experience, and the omission at one plant location of records summarizing shrinkage experienced by

major component. As a result, excessive quantities of materials were procured, resulting in the acquisition of about \$360 thousand in unneeded items. Appropriate recommendations were made and adopted by the contractor, which resulted in improving its controls and avoiding recurrence of excess procurements.

3-S106 Contract Audit Disclosures on Contractors' Intracompany Transfers of Materials**3-S106.1 Classification of Commercial versus Cost-Based Parts**

A major naval weapons system producer stated that certain items procured from its other divisions were standard commercial items. This warranty was used as an "as is" for charging interdivisional transfers to government contracts at selling prices rather than at cost. In some instances, it was determined that the standard commercial parts were in fact only remotely related to commercial items because of the substantial modification required to meet the military design and specifications. Consequently, over \$2.6 million of parts costs were questioned on the basis of the incorrect classification of these items as standard commercial parts. Most of this amount was recouped from the contractor as a price reduction due to defective pricing.

3-S106.2 Burdening of Catalog Prices

At one contractor, certain items were charged to a government contract at catalog prices. The contractor also allocated administrative costs to the catalog items. The allocation was questioned on the basis that the catalog price already included all costs (and profit) to the contractor, and that any further allowance would be a duplicate recovery of expense, in accordance with the contract cost principles. The contractor concurred in an adjustment of \$175 thousand and changed its allocation procedures for such transactions in the future.

3-S107 Contract Audit Disclosures on Contractors' Accounting for Material Costs**3-S107.1 Consistency of Standard Costs for Commercial Versus Government Work**

A contractor maintained a standard cost accounting system for both government and commercial work. Quantity and price variances were applied proportionately to all work. The standards on commercial items had not been adjusted for many years, whereas government standards were repeatedly revised and updated to reflect higher current actual costs. As a result, the standards on commercial items were considerably less than actual costs, resulting in an inequitable over-application of the variances to government work. The over-application, amounting to \$82 thousand on one contract, was questioned by the auditor. The contractor concurred in this adjustment and made appropriate revisions to its standards so that this condition would not recur.

3-S107.2 Costing of Purchases before Usage

A contractor's method of accounting for common usage of low-dollar-value items was found to be inadequate in that such items were charged to cost reimbursement type contracts when purchased, although these items were actually placed in storage and issued only as needed for contract performance. As a result of this incorrect accounting treatment, these items were gradually accumulated in inventory, but not recorded as assets. At the time of the auditor's review, the unrecorded inventory amounted to approximately \$800 thousand. The auditor recommended that the contractor establish proper controls to account for the usage of these materials. The contractor concurred in this recommendation and issued appropriate credits to the open cost reimbursement type contracts which had financed their purchase.

3-S107.3 Credit for Change in Inventory Methods — Most Favored Customer Clause

An allocable portion of gain realized by an electrical apparatus contractor

through revaluation of inventory and retroactive adjustment of costs was not credited to the government, although the contractor had warranted that the government was charged at most favored customer prices. The gain, due to the contractor's change from the last-in, first-out (LIFO) method of inventory valuation to the first-in, first-out (FIFO) method, resulted in an increase in total inventory value, as of the date of revaluation, of about \$52 million, which the contractor credited to earned surplus. For periods prior to the date of revaluation, government contract costs had been charged on the basis of the higher amounts resulting from use of the LIFO method. The auditor recommended that the contractor credit the government for its share of the adjustment, estimated at about \$900 thousand, on the basis that the most favored customers which were affiliated companies were supposedly charged at cost, and the contractor had contravened its price warranty by retroactively superseding its cost accounting system.

3-S108 Contract Audit Disclosures on Contractors' Handling of Spare Parts Purchases

A contractor subcontracted for significant quantities of spare parts which were the same as the components of the end item it was producing. The spare parts suppliers were located in many sections of the nation. All of these parts were received and inspected at the contractor's plant, unpacked, stored, and later repacked and reshipped to various government depots. The auditor in conjunction with the ACO's technical representative recommended that the contractor arrange for inspection of parts at the source, and their direct shipment to the government depots, an alternative procedure permitted by the contract. The auditor supported the recommendation with cost data showing the amounts incident to repacking and reshipping the parts which could be saved by source inspection and direct shipments. The contractor adopted the recommendation; it is expected to result

in savings of about \$75 thousand per year.

3-S109 Contract Audit Disclosure on Contractors' Production Control Procedures

3-S109.1 Segregation of Scrap and Rework Costs

The review of production control procedures of an electronics parts manufacturer disclosed weaknesses in the company's scrap and rework control procedures. Direct labor cost for scrapped and reworked units was commingled with other direct labor, thus preventing accumulation of accurate information as to the costs of rework and scrap, estimated to be at least \$300 thousand per year. This precluded management from evaluating the extent of production control deficiencies and from initiating prompt corrective action. The contractor agreed to institute controls to correct this situation in the future.

3-S109.2 Controlling Indirect Effort to the Level of Operations

At a large research and development contractor, audit analysis of production control data showed that indirect costs continued to rise notwithstanding a downward trend in the level of operations. The auditor's further analysis disclosed weaknesses in indirect labor assignments, work identification, and performance review. As a result, over \$3 million of indirect labor costs were questioned as being excessive to the needs of the contractor and the government. During negotiations the contractor agreed to absorb an appreciable amount of the \$3 million. Appropriate corrective controls were instituted by the contractor to prevent recurrence.

3-S110 Contract Audit Disclosures on Contractors' Indirect Costs and Allocation Methods

3-S110.1 Controlling Indirect Costs for Declining Business Volume

At a major communications equipment contractor which performed predominantly cost-reimbursement type con-

tracts, the auditor's trend analysis indicated a 27 percent increase in overhead costs over a five year period while production volume decreased by 30 percent. Normally, a decline in production volume will result in some increase in overhead percentage rates because, while variable overhead costs may decline somewhat, the non-declining fixed overhead costs must be absorbed by a smaller production base. In this case overhead costs were increasing both percentage-wise and in total amount. Accordingly, the auditor recommended that the cognizant contracting officers establish appropriate overhead ceiling limitations for all contracts at this plant to insure that the government would not bear unreasonable overhead costs. Actions were taken to provide for such limitations in subsequent contracts awarded to this contractor.

3-S110.2 Double Counting of Capital Equipment Charges

A metal fabricating contractor followed the policy of charging directly to its government contract the leasing cost of basic capital equipment which had been obtained to provide the expanded capacity required to perform the contract. This treatment was inconsistent with the contractor's normal accounting system, since charges for similarly owned facilities used to perform other work were included in the contractor's overhead accounts which were allocated to both government and commercial work. The direct contract charges were questioned by the auditor on the basis of this inconsistent treatment. The result was a net reduction of \$781 thousand in costs charged to the government contract.

3-S110.3 Shifting Commercial Overhead to Government Work

The auditor's functional review of an electrical products contractor's overhead allocation methods disclosed the contractor's practice of allocating shop department overhead on the basis of a single average rate for all shop departments rather than a separate, readily determinable rate for each shop department, resulting in loading government work with some of the higher overhead costs in-

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curred in shop departments primarily engaged in commercial work. This resulted in excess charges to government work of about \$150 thousand and \$120 thousand in two successive years. The negotiating contracting officer gave appropriate recognition to this factor in establishing overhead rates for these years.

**3-S111 Contract Disclosures on
Contractors' Management of
Government-Furnished Property**

A not-for-profit contractor maintained accountable property records of govern-

ment property with an acquisition cost of about \$17 million. Audit review disclosed that accounting and physical controls were inadequate with respect to a large portion of this property and that a physical inventory had not been taken for several years. Unauthorized use of this property was noted and reported. Suggestions were made in the audit report that would result in more efficient property management with related cost savings.

3-S20 Supplement — NASA Recommended Areas of Coverage (For Audits of NASA Contracts and Contractors) (Ref. 15-106)

3-S201 Introduction

a. The following paragraphs set forth areas of audit coverage considered to be of importance in the review of large dollar value NASA contracts. These areas have been suggested and identified by NASA procurement personnel as particularly significant in view of that agency's contracting policies and procurement management programs. It will be noted that with the exception of the special coverage set forth for NASA Form 533, these areas would also normally be encompassed in the audit program of DoD major contractors. Consequently, the integration of proper coverage for these areas into the audit plan for contractors having a large volume of DoD and/or NASA auditable contracts should not present any additional work.

b. The scope of review and the extent of coverage to be accorded to the individual areas will be determined by the DCAA auditor, who is fully responsible for the development of the audit plan and its performance. In any event, it would be expected that the DCAA auditor would have carefully considered the matters presented below, to the end that the overall audit plan will provide adequate coverage of the contractor's total auditable activities and contracts.

c. Where requests for special audit coverage or emphasis are received from NASA procurement or audit personnel, they should be considered in the light of the foregoing, for orderly performance in accordance with the audit plan. If performance of any such request will adversely affect accomplishment of the audit plan, the DCAA auditor will discuss the matter with the regional director prior to reaching a decision on the request. When deemed necessary, the regional director may also consult with Headquarters, DCAA, regarding the request.

3-S202 Performance Controls

In view of the technical ramifications of this area of activity, it is recommended

that any performance problems disclosed be coordinated with responsible technical project personnel. Illustrative of the types of matters warranting attention and coverage are:

a. Disproportionate relationship of production schedules to contractual delivery requirements.

b. Excessive rework of subsystems, component parts, etc. In this connection, ascertain whether vendor-fabricated components reworked by the company should have been returned to vendors for rework or replacement at their own expense because of failure to meet specifications.

c. Lack of consideration of available facilities and plant capacity in development of production schedules.

d. Significant production slippages. The related impact on costs and personnel utilization should be explored and emphasized. The steps taken or planned, if any, to recoup schedule losses, etc., should be reported.

3-S203 Contractor Financial Management

a. All actual and potential cost overrun conditions should be appropriately analyzed for each contract. To the extent feasible, explore and report the contributing factors such as:

(1) Misunderstanding of work requirements.

(2) Inadequate cost estimating procedures.

(3) Ineffective coordination between the contractor's technical and administrative officials at the time that redirection of effort or changes in scope are undertaken.

(4) Poor communication to or reporting among the prime and subcontractor representatives. For example, subcontractors sometimes incur cost overruns long before the prime contractor or NASA knows. Reports between the above, if made on a timely basis, would in many instances predict the overrun or the underlying problems.

b. Audit coverage of this area should include an assessment of the contractor's policies and procedures for development and maintenance of historical costs and forecast data to be used in preparing financial management reports, price proposals, etc.

c. Review should also be made of the company's procedures for preparing annual company-wide budgets and for comparing on a periodic basis incurred costs with budget data (5-500). Matters which should be considered include the following:

(1) Adequacy of budgetary control procedures for individual NASA contracts. In this connection, determine whether the estimated costs of individual projects, tasks, and departments, as included in the contractor's bid proposals, agree with (1) the amounts budgeted for the individual projects, tasks, and departments and (2) the total estimated costs shown in the Forms 533 or equivalent reports. Also, ascertain whether costs incurred are accounted for in a manner to permit comparisons with the estimated costs of individual project tasks and departments, as shown on the contractor's price proposal and budget. The evaluation should cover the adequacy and reliability of the data generated by the contractor's system as well as the use made of these reports by the contractor.

(2) The NASA FAR Supplement 4.675 provides for contractors to report periodically on NASA Form 533 (Contractor Financial Management Report) to NASA field installations. This form is designed for contractors to submit their financial and manpower experience and projections. Contractors are required to furnish a separate report periodically for each NASA cost-reimbursement type contract on which the estimated cost is expected to be \$500,000 or over and on which the period of performance is expected to be one year or more. Contracting officers may also require submission of this report, where deemed advisable, for contracts not meeting these criteria.

d. Auditors should selectively review the current reports for each contract as follows:

(1) Current cost experience and engineering estimates are normally required

to be used in reporting the estimated cost to complete the contract. The auditor should ascertain whether such estimates were used and whether the amounts reported in the form agree with the estimates. There should be logical explanations for any differences.

(2) Where current cost experience and engineering estimates are not used, the auditor should evaluate the methods used for reporting the estimated cost to complete. In some instances, contractors arrive at these amounts by merely deducting the cumulative incurred cost to date from the total contract amount (exclusive of fee). This procedure is unrealistic, particularly where known cost overruns have already occurred in certain phases of contract performance. Since subcontract costs are often a substantial part of the total, it is particularly significant that the contractor's procedures for obtaining realistic subcontract data be reviewed for adequacy.

(3) The auditor should ascertain whether the contractor's procedures for internal review of NASA Forms 533 prior to their issuance are adequate. For example, if the reports are prepared by the accounting department, they should, as a minimum, be reviewed by the contractor's cognizant contract manager to insure their accuracy and currency.

(4) Where there is a significant upward trend in labor costs, the reasons therefor should be ascertained and reported. Some of the reasons for this condition may be (1) improper controls over production methods, resulting in failure to detect inefficiencies or (2) increases in hourly rates without a corresponding increase in productivity.

(5) Causes for excessive or unusual increases in overhead and G&A expense rates during the course of contract performance should be analyzed. Evaluate action taken by the contractor to control the rates.

e. In some cases, the data and reports submitted to NASA are generated by a separate system from that used by the contractor for internal control of its functions and organizations. In these situations, the auditor should ascertain whether the data generated by the system used for contractor purposes are fully compat-

ible with the data submitted in reports to NASA. All pertinent data should be reported to NASA regardless of whether required by the NASA reporting system.

f. In those cases where PERT or an equivalent system is required by NASA for control of project operations, the auditor should evaluate the adequacy of the system to establish:

(1) Whether duplicate PERT or related systems are being used by the contractor. The basic NASA-PERT system policy requires establishment of only summary-type networks and cost reports thereon. Use of the PERT system at lower levels is generally optional to the contractor. However, if PERT networks are developed at a lower level of detail than that required by NASA, determine whether the contractor's project managers are actually using the more detailed PERT system or relying on a separate system of their own.

(2) Whether the costs of operating the NASA-PERT system are charged both as direct and indirect costs. Inasmuch as many of the activities associated with the operation of the system are closely related to the general process of management, that is, project management, planning, scheduling, accounting, etc., all or at least the major portion of the costs should normally be indirect. In those cases where NASA contract costs are charged direct for activities which are normally treated by the contractor as indirect costs, similar costs directly applicable to the contractor's other business should be excluded from indirect expense pools allocated to all work.

g. A comprehensive plan by the contractor to control work performance is essential for effective financial management of R&D contracts. The plan should establish under each task and project, to the extent appropriate, a method for work surveillance. The method usually provides for the establishment of milestones which represent definitized progressive targets or stages to be reached during the progress of the work. For each milestone, records should be maintained to determine the effectiveness of performance by considering variances between the target and actual dates and variances between estimated costs and actual costs.

The following guidelines should be used to evaluate the contractor's efforts to manage work performance:

(1) For selected contracts, evaluate the adequacy of contractor management reviews of the progress of work performance. Audit evaluation should include an examination of reports and/or minutes prepared to cover the reviews. Ascertain the extent that the reviews considered the correlation of the physical or technical progress of the work with the costs incurred.

(2) Where the deliveries of items or completion of the tasks under the contract were past due, determine whether contract costs increased as a result of the stretch-out of work.

(3) Ascertain whether time delays in completing phases of work were attributable to weaknesses in planning. For example, insufficient lead time may have been planned for the construction or acquisition of the necessary facilities to perform scheduled tests.

(4) Evaluate the number and significance of engineering changes, considering such factors as the number of change orders issued and the justification given for the changes. Determine whether fixed fees were increased or decreased commensurately with the change in the scope of work. If the fee was unchanged, determine whether a decrease was warranted.

(5) Examine the contents of technical reports issued under the contract to relate comments on technical progress to periodic financial reports. Is there evidence of technical difficulties which are not adequately reflected in estimated costs to complete the contract?

(6) Make arrangements to attend periodic NASA-contractor or meetings on work progress. Relate problem areas discussed at these meetings with contents of periodic contractor reportings on costs and on status of funds.

(7) Ascertain and evaluate the extent that contractor representatives maintain surveillance over subcontractor operations. Do subcontractors furnish prime contractors with periodic reports on technical and financial progress? Are such reports prepared in a manner compatible with the data required in the NASA Form 533?

(8) Ascertain whether contractor representatives are required to prepare trip reports covering each visit to subcontractors. Evaluate the reports from the standpoint of business management functions. For example, where the need for additional funds to complete the work was reported, was appropriate action recommended and taken? Particular attention should be given to whether the reports covered the status of physical or technical progress in relation to costs incurred.

3-S204 Purchasing and Subcontracting Practices

a. Make-or-Buy Decisions

Audit inquiry should be made into the contractor's policies and procedures in arriving at make-or-buy decisions. Audit inquiry should cover the composition of the committee or group responsible for such decision-making, the guidelines or factors to be considered in the decision process, and the nature of the documentation maintained in support of the decisions. Evaluate selected make-or-buy decisions.

b. Subcontractor Selection and Subcontract Administration

Many of the concepts relating to procurement activities by NASA in-house procurement elements have similar applicability to subcontracting and other purchasing actions by the prime contractor and higher tier subcontractors. The following are some of the significant points to be covered:

(1) The methods used by the contractor for selection of subcontractors and principal suppliers should be reviewed to assure that appropriate consideration is given to adequacy of subcontractor facilities, financial capabilities, and technical know-how.

(2) The type of subcontractual instruments used by the prime contractor should be evaluated as to their appropriateness in the individual circumstances (cost-type, incentive, time and materials, etc.)

(3) The audit should establish that the prime contractor conforms with the requirements of the contract by obtaining necessary contracting officer approvals of subcontracts.

(4) The sufficiency of cost and price analysis by contractor personnel should be examined in the light of the extent of competition obtained. It should be ascertained whether subcontractors were required to furnish adequate details of cost and profit make-up to permit evaluation and comparison of prices quoted. The nature and extent of further negotiations with the supplier awarded the subcontract should be reviewed. Special attention should be given to those cases where the successful bidder was other than the low bidder to ascertain that sufficient justification existed for the award.

(5) Selected subcontracts should be reviewed for possible ambiguities, absence of or revisions to standard clauses, contradictions of requirements, etc. For example, are delivery schedules in the subcontracts compatible with work requirements in the prime contract?

(6) Are engineering change orders promptly transmitted to subcontractors and are price changes due to such change orders negotiated promptly and at reasonable prices?

(7) Relative to (6) above, are delivery delays promptly pursued?

(8) Are required technical, administrative, and financial reports submitted by the subcontractors to the prime contractor? Are such reports being used for subcontract management purposes?

(9) Have necessary arrangements been made for contract administration, audit, etc., at the subcontractors for the interchange of pertinent information?

3-S205 Inventory Management

Effective inventory control is essential to assure a proper balance between inventory supply and production requirements. Among the matters to be included in the review of this activity are:

a. Indications of overbuying, tying up funds in excess inventories which are not contributing directly to the current program.

b. In establishing inventory requirements, is consideration given to the problems of frequent change orders obsoleting certain items?

c. Does the contractor have a program for standardization of component parts

as a means of reducing the need for separate buying for individual contracts?

d. Items of material identified as excess, obsolete, or otherwise in long supply should be examined as to the cause of these conditions. Conversely, items in short supply should be similarly reviewed for causes.

e. Are effective procedures used to evaluate the economic reparability of production rejects?

f. The contractor's procedures for disposal of scrap should be evaluated. For example, are classification procedures adequate to determine what is usable, salvage, or scrap; are competitive bids secured for sale of scrap?

3-S206 Engineering and Scientific Manpower Utilization

a. It is important to emphasize in this area that it is neither contemplated nor intended that the auditor evaluates technical performance as such. However, the auditor can, for example, be of substantial benefit in helping to ascertain whether the financial controls are adequate to assure that NASA is obtaining commensurate value, in terms of level of effort and output, from the cost input in this area.

b. In light of the above, review in this area should cover:

(1) The system of internal management controls established by the contractor to accumulate and report data with respect to time expended by engineering and scientific personnel and the progress made.

(2) The reliability and completeness of the recorded data and the reports submitted to contractor and NASA management.

(3) The action taken by the contractor's management to control direct engineering and scientific effort.

(4) Coordination between technical and administrative personnel.

3-S207 Facilities and Equipment

Audit inquiry in this area should include such matters as:

a. The relationship between the investment of the contractor and of the govern-

ment in facilities for contract performance. This relationship is significant in evaluating the reasonableness of fees in relation to estimated contract costs, since a relatively high government investment should ordinarily be reflected in a lower rate of fee than would be the case where the contractor utilized its own facilities.

b. Procedures used by the contractor to secure new and unused production equipment. Do such procedures include provision for attempting to secure government-owned equipment?

c. Are government-owned facilities being used by contractors on commercial work for which a lease arrangement has not been effected?

d. Is there any idle government equipment at the contractor's plant? If so, has it been reported to responsible NASA officials? If not reported promptly, delays could result in contractors at other locations procuring like equipment unnecessarily.

e. Is there evidence of unused or partially unused plant facilities? If so, what is the effect on the NASA contracts? For example, where only partial use is made of facilities, NASA may be inequitably sharing the fixed overhead applicable to the facilities. Review should also be made to ascertain whether the contractor is performing work on the same contract at more than one plant when adequate facilities and capacity are available at a single plant.

f. What controls are exercised to assure that previously acquired capital assets reimbursed by the government are not considered in pricing subsequent procurement?

3-S208 Engineering Changes

This area is particularly significant in the light of its impact on costs and potential overruns. Audit review should therefore be directed toward:

a. Evaluation of the contractor's procedures for the implementation of engineering change orders. Do the procedures provide for measuring the cost of the change (upward or downward) against the nature of the technical modification?

b. Review of the contractor's estimating procedures to determine their reli-

ability as a basis for negotiation of changes to the contract price.

c. Is effective coordination established with subcontractors affected by engineering changes? Are costs of making changes at subcontractor's plants appropriately considered?

3-S209 Indirect Costs

Depending on the sensitivity and dollar significance of the indirect cost elements, audit coverage should encompass, in addition to the verification aspects, assurance that the contractor's policies and procedures under which the costs were incurred are reasonable and whether management controls are effective in precluding the incurrence of excessive or unnecessary costs. Special attention should be given to such sensitive and controversial items as:

- a. Independent research and development and bid and proposal costs (see 7-1500).
- b. Bonuses
- c. Pension, and profit-sharing plans (see 7-600).
- d. Overtime costs (see 6-400).

e. Executives' compensation (see 5-808.3).

f. Recruitment costs (see 6-400).

g. Pre-contract costs (see 6-200).

h. Royalties and other costs for use of patents (see 7-700).

i. Travel and relocation expenses (see 7-1000).

3-S210 GAO Audits

Information concerning GAO audit activities is understandably of particular interest to NASA management. Accordingly, report coverage should include appropriate data and commentary on such matters as:

- a. Have the NASA contracts been audited by the GAO from their inception to date? If so, the approximate dates of each audit should be indicated.
- b. The major GAO comments (oral and written), areas of interest, etc.
- c. GAO reports issued. Include title, number, date, major findings, chief recommendations, contractor responses, AF and Navy responses, NASA responses, action taken by the company, agency, contracting officials, auditors, etc.

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CHAPTER 4**4-000 GENERAL AUDIT REQUIREMENTS****4-001 Scope of Chapter**

This chapter presents general guidance and basic auditing concepts and techniques to assist the auditor in accom-

plishing the objective of contract auditing. Amplification of this guidance will be found in later chapters and appendices.

4-100 Section 1 — FAO Coordination with Contract Administration Personnel**4-101 Introduction**

This section presents guidance on general coordination with procurement and contract administration personnel.

4-102 Coordination with Contractor and Government Contract Administration Personnel

a. The maintenance of effective communications and interface with the people with whom DCAA is involved in day-to-day operations is an important aspect of the audit function and is referenced in various sections of CAM dealing with operational auditing matters.

b. Periodic visits are made to various field audit offices by DCAA regional personnel (RD, DRD, RAM) in conjunction with reviews of the adequacy and status of audits performed by such FAOs. Occasional visits are also made to FAOs by members of the DCAA Headquarters staff in connection with their assigned duties. In view of the importance of effective communication, regional and Headquarters personnel should, during visits to FAOs, make a reasonable attempt to arrange for meeting with appropriate contractor and government contract administration officials. The primary purpose of such meetings is to provide contractor and government representatives with an opportunity to express their views on relationships with DCAA and any significant developments or problems where DCAA may be involved or be able to provide assistance. In addition, it is expected that significant audit matters and problems requiring the

cooperation or assistance of contractor or government contract administration personnel would be discussed at these meetings. Discussions should be informal and conducted with an objective of mutual benefit.

c. In the case of visits to branch offices, it is contemplated that contacts would ordinarily be limited to contractor representatives at suboffices visited and government contract administration offices in the same locality as the branch offices or suboffices visited.

4-103 Reserved**4-104 Results of Negotiations and Findings on Appeals**

a. FAR provides that the contracting officer shall forward to the cognizant DCAA auditor one copy of the Price Negotiation Memorandum (FAR 15.808), Memorandum of Disposition of Post-award Audits (FAR 15.804-7(d)), and Final Determinations on Contractor Appeals to DCAA Forms 1. These documents concerning the disposition of audit findings are needed for determining whether revisions in audit techniques and related reporting may be in order, to enable the auditor to be as responsive as possible to the needs of the contracting officer. In addition to serving as a key element in the auditor's continuing self appraisal process, the data are needed for reporting to top management levels in the departments and to the Office of the Secretary of Defense. In order to be timely and fully responsive to the needs of DoD management in providing infor-

mation on audits, negotiations, etc., all field audit offices will establish formal follow-up procedures to ensure that copies of these contracting officer advices are timely received and promptly reported in the status reports required by Headquarters.

b. If the memorandum provided for by FAR 15.808 is not received by the auditor within 90 days following issuance of the audit report, and negotiations are known or expected to be completed (for price proposals, questioned costs should exceed \$50,000 to warrant follow-up), the field audit office will take follow-up action requesting a copy of the document directly from the cognizant procurement or administration activity with a copy of the request to the full-time on-site PLA or assigned part-time PLA. If necessary, the field audit office should issue a second follow-up request, identified as such, within 90 days of the first follow-up request for the PNM. Upon receipt of the second follow-up request, the full-time or assigned part-time PLA will become responsible for all further follow-up until the contracting officer distributes the PNM. Where the PLA encounters a continuing problem with timely distribution of PNMs, and corrective action is not effected, the PLA should elevate the matter for resolution by the region with

its counterparts in the acquisition or administration activity.

c. Those activities with full time PLAs are listed in 15-3S1. To determine if a part-time PLA has been assigned, contact the regional office responsible for the geographical area where the activity is located.

d. Auditors at subcontractor locations also require similar information relating to prime contractor or higher tier subcontractor negotiations with subcontractors. This information is needed for postaward auditing, assessing performance, and reporting purposes. The auditor at the prime contractor or higher tier subcontractor location should ensure that maximum support is given to subcontract auditor requests. In the event a contractor refuses to release the information for use outside its organization, it will be necessary for the auditor at the prime contractor or higher tier subcontractor sites to review the subcontract file and report pertinent information to the subcontract auditor.

e. Follow-up is required for copies of Final Determination on Contractor Responses to DCAA Forms 1. 6-908d states that the auditor must have received a copy before a resubmission voucher can be processed.

4-200 Section 2 — Coordination with Contractor Internal and External Auditors

4-201 Introduction

This section discusses many factors for maintaining effective relationships with contractor internal and external auditors.

4-202 Relationships with Contractor Internal and External Auditors

4-202.1 Coordinated Audit Planning

a. The auditor's evaluation of a contractor's internal controls, pursuant to 5-100, may disclose, particularly at a major defense contractor location, that a contractor maintains a highly professional internal audit staff. In addition, most larger contractors also engage an external public accounting firm to conduct an audit of their financial statements. While these internal and external auditors' final audit objectives are not the same as DCAA's, the means of achieving these differing objectives often overlap. This frequently results in duplicative audit procedures. Whenever there are multiple audit organizations involved, consideration should be given to coordinated audit planning. Such a program must, of course, be predicated upon the contractor's agreement to make available to DCAA relevant internal and/or external audit working papers and reports (see 4-1000). Since the external auditor's working papers do not belong to the contractor, there must be agreement between the contractor and the external auditor to provide access to DCAA. This may be accomplished in the engagement letter. Also, before communicating directly with an external auditor regarding contractor information, a letter should be obtained from the contractor indicating that there are no objections to such communication.

b. Coordinated audit planning is a voluntary process wherein DCAA and the contractor's internal and external auditors consider each other's work in determining the nature, timing, and extent of auditing procedures. Coordinated audit planning considers the extent to which reliance can be placed upon work

performed by the other auditor to minimize duplication of audit effort. In addition, this process strengthens the evaluation of internal control systems.

c. The primary benefit of coordinated audit planning is that it promotes contractor self-governance, enabling organizations to better develop and maintain strong systems of internal controls. Coordinated audit planning also helps identify and eliminate duplicative audit effort, thus saving resources for all parties. It is an efficient and effective means for conducting oversight and it provides contractors with better visibility into and understanding of government oversight criteria. This promotes communication, cooperation, and respect among the various auditors.

d. The coordinated effort may be accomplished either through the adoption of complementary audit programs for separate performance by the respective audit staffs or through joint audits. The sharing of overall annual audit plans or participation in such programs as the Contractor Risk Assessment Guide does not constitute a joint audit. A joint audit is one in which the government and the contractor have mutually assessed risk, developed an audit program, and conducted field work in the audit of a particular area. When audit steps are performed jointly, each audit organization will maintain supervisory responsibility over its respective audit staff.

e. In some instances, for reasons such as limitations imposed on the scope of the contractor's internal audit activities, it may not be feasible or desirable to adopt a joint audit approach. However, even in such instances, the work of the contractor's internal and external auditors should be considered in assessing risk and in establishing audit scope. Areas particularly appropriate for consideration include tests of the overall accuracy of computations, accounting records, compliance with established internal controls and procedures, material and inventory pricing, payroll preparation, labor distribution, and accounts payable. To

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reduce the extent of audit work which would otherwise be performed by the DCAA auditor, reliance should be placed on the contractor's internal and external audit activities commensurate with the nature, scope, and effectiveness of work performed. See 4-1000 for documentation requirements when relying upon the work of others.

f. When a report is received from the contractor's internal or external auditor that indicates significant audit deficiencies or major problems with billings to the government, the auditor should conduct a timely factfinding of all issues and communicate the findings to the proper government personnel. All verbal communications should be confirmed in writing on a timely basis (see 1-403.3).

4-202.2 Access to DCAA Working Papers

a. Under a coordinated audit planning program the contractor's internal or external auditors are authorized access to most relevant DCAA working papers. However, contractors' internal and external auditors are not authorized access to the following:

- (1) DCAA Form 2000.0 and associated working papers.
- (2) Audit reports and associated working papers when reports have a contingent release statement (see 10-206.2). These may be released with permission of the contracting officer.
- (3) Government technical reports and post-negotiation memorandums. These may be released with permission of the originator.
- (4) Reports or information on subcontractors. This information may be released if authorized by the subcontractor.
- (5) Administrative forms or appraisal evaluations.
- (6) Classified working papers.
- (7) Working papers discussing unsatisfactory conditions on the part of government personnel (see 4-803.2b)

b. DCAA working papers are considered government property and, as such, DCAA must maintain physical custody. To the extent practical, the other auditors should satisfy the evidence requirement by reference to, or notes and extractions from, DCAA working papers. Copies

should generally be made only when referencing notes or extraction would not be practical. If copies are required, the other auditor should provide a list to the DCAA auditor who in turn will arrange for reproduction. A list of the documents provided will be retained in the DCAA working papers.

4-203 DCAA Response to Accounts Receivable Confirmation Requests from CPA Firms

a. Auditors occasionally receive requests from CPA firms to confirm the amounts represented by their clients as receivables due from the government. These requests normally apply to contracts where provisional approval for interim payment of costs incurred to date is DCAA's responsibility. Confirmation of receivables is a generally accepted auditing procedure whereby the CPA seeks to verify the existence and accuracy of the dollar amounts reported as accounts receivable on the contractor's financial statement. Under government contracting, it may be expected that the CPA will request positive rather than negative confirmation; in either case, it is DCAA policy to acknowledge each request.

b. Contractors usually establish a receivable under cost-reimbursement type contracts, in the amount of a public voucher, at the time it is submitted to the auditor. However, we cannot reasonably determine the exact timing of contractor payment by the disbursing office or the total amounts unpaid at any prior point in time. Furthermore, public vouchers represent claims for interim payments which are provisional in nature and subject to retroactive adjustments at any time prior to approval and payment by the government of the contractor's completion voucher. Therefore, the auditor is not in a position to issue an unqualified confirmation of accounts receivable amounts, and could not issue a qualified confirmation of outstanding billings without the disbursing office coordination.

c. A confirmation request may also include contract billings which are not

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subject to audit approval, such as for progress payments, economic price adjustments, or deliveries under fixed-price type contracts. It is not appropriate for DCAA to expend any effort attempting to confirm such billings.

d. Because of the above considerations, auditors will not attempt to confirm amounts claimed by contractors as due from the government. Tactfully and promptly acknowledge a CPA's confirmation request by letter, with a brief statement as to why we are not in a position to confirm a contractor's accounts receivable. Also provide, if available, the name and address of the government disbursing office where additional information may be pursued if the firm so desires. For example, the acknowledgment might read:

We acknowledge receipt of your confirmation request dated 15 August 1984, concerning amounts represented by the XYZ Company as due from the Department of the Army as of 31 July 1984.

Until completion of a cost-reimbursement type contract and later final settlement of the costs, we are not in a position to confirm that amounts claimed by a contractor are payable under the contract. Also, under any type of government contract, we cannot determine the unpaid billed amount at any prior point in time because we do not maintain records of payments made.

If you wish to pursue confirmation of the outstanding billed amounts, we suggest that you address your inquiry to the Army Finance Office, (address).

4-300 Section 3 — Conferences With Contractors on Audit Plans, Interim Notifications, and Results

4-301 Introduction

a. This section provides guidance on audit conferences with the contractor. It states the basic requirements for and the extent and nature of discussions during entrance, interim, and exit conferences in general and under each type of audit assignment.

b. Regarding contractor conferences in the mobile audit environment, see supplementary guidance as follows: (1) supervisory auditor participation (G-404g), (2) branch manager participation (G-405c), and (3) special advice and assistance to small contractors (G-502).

c. Special guidance on preliminary conferences after a contract termination (before the contractor submits a settlement proposal) is in 12-205.

d. Conduct all discussions with contractors with objectivity and tact in a forthright, professional manner.

4-302 Entrance Conferences

4-302.1 General Procedures for Entrance Conferences

a. Except as provided in 4-302.4, hold an entrance conference with the contractor's designated representative(s) at the start of each separate audit assignment (or each group of assignments to be covered in a single field visit). Document the date, participants' names and titles, and primary discussion points, including specific identification of requested data to control what was requested and provided during the audit. The significance or sensitivity of the assignment will dictate the level and number of audit personnel who should attend the conference.

b. As a minimum, explain the purpose of the audit, the overall plan for its performance including the estimated duration, and generally the types of books, records, and operational data with which the auditor will be concerned. If applicable, the following matters should be handled during or shortly after the entrance conference:

(1) Make arrangements for any necessary work space and administrative support. Primarily, this applies to mobile assignments; however, auditors in a resident office or suboffice may also need temporary space in a particular operating location to expedite a functional/operational review.

(2) Ask the contractor to designate primary and alternate officials with whom audit matters are to be discussed during the course of the assignment. However, make it clear that such an arrangement does not preclude access to other knowledgeable contractor personnel as needed during the audit. Also make it clear that these arrangements should not cause delays or extra audit work (hence the advisability of having named alternate officials to expedite the audit should the primary official be unavailable). Complex, detailed, and time consuming procedures, such as requiring all data requests be written and/or funneled through a single individual only, are an obstruction to efficient audit operations. Contractor representatives' actions which unreasonably restrain, restrict, or delay the audit should be processed using the denial of access to records procedures set forth in 1-504.3.

(3) Discuss, or obtain a briefing on, the contractor's proposal(s) or other cost representation(s) to clarify any preliminary questions, understand the basis of each submitted cost element, and learn the nature and location of supporting data.

(4) Visit all office and/or plant operating areas used in performing current and proposed contract(s).

(5) Arrange to review the planning documents, working papers, and audit reports of the contractor's internal and external auditors for any reviews performed or planned that may curtail the planned scope of work. See 4-202 for guidance on coordinated efforts with the contractor's auditors.

(6) Arrange for any needed EDP audit assistance (see 4-500).

(7) When the assignment involves a subcontractor's cost representation(s), re-

solve any restrictions on release of audit findings and report information to higher-tier contractor(s) per 9-106.4.

(8) Do not enter into written agreements with contractors, or affix concurrence signatures to contractor letters, which contain procedural arrangements that inhibit and/or delay the audit performance or restrict the reproduction of necessary supporting evidential matter.

4-302.2 Special Considerations for Entrance Conferences on Major Functional/Operational Reviews

a. Hold a planning meeting with the contract administration office technical specialist(s) in advance of the joint entrance conference with the contractor, whenever technical assistance is being provided or a joint review is being conducted under the DFARS Subpart 242.70 cost monitoring program. The technical specialist(s) should help develop the entrance conference agenda, such as identifying necessary data to be requested from the contractor. Also invite the specialist(s) to participate actively in the conference itself.

b. Notify the contractor's management several weeks before starting an operations audit or other major functional review. This notice may be oral or in writing depending on resident working arrangements (4-302.4).

c. As applicable, mention the following matters during the initial contact before the entrance conference, and follow up during the entrance conference on each major functional/operational review in addition to those matters common to all assignments (4-302.1).

(1) Request the cooperation of the contractor's top management and functional area management to expedite the review.

(2) Give the contractor's management personnel an opportunity to explain how they have discharged their responsibilities to establish and maintain adequate internal accounting and administrative controls in the review area.

(3) Request the contractor to identify all reports and analyses used by any management level to evaluate and control the effectiveness, economy, and efficiency of the review area.

(4) Request the contractor to provide an informational briefing on the organization and operations involved in the area to reduce the review time. Such briefings may cover: (1) organizational/functional assignments affecting the area, (2) system descriptions and/or flowcharts of transaction flows and system controls, and (3) any identified problems and planned corrective actions or other planned changes in the area.

(5) Invite the contractor to participate actively in the review.

(6) Explain in advance the DCAA procedures for submitting draft statements of conditions and recommendations, and establish time frames for the contractor's written responses (see 4-304.5b).

4-302.3 Confirming Letter on Certain Major Assignments

Issue a letter to the contractor on major functional/operational reviews, confirming the arrangements made and significant matters discussed at the entrance conference. Keep the letter's tone courteous and express appreciation for the arrangements made. At the FAO's discretion, use a similar letter for other major audit assignments to help maintain good working relations with the contractor. However, make it clear that the arrangements should not in any way restrict access to records or personnel necessary to the audit performance. Predeterminations of all records, facilities, contractor personnel, etc. that may be needed before starting an audit are not possible.

4-302.4 Resident Working Arrangements for Entrance Conferences

a. Where auditors are assigned full time at the contractor site, it is usually desirable to establish local working arrangements for entrance conferences with the contractor. For example, some contractors may require that the auditor contact certain key personnel before starting specific types of audits (but see 4-302.1b.(2)). The contractor may designate a permanent government liaison representative for audits of a general nature, or the contractor's controller as the contact point for any financial system or compliance type review and the chief

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of estimating as the principal contact for price proposal reviews. A contractor might also desire a formal entrance conference only on major or nonrecurring reviews while price proposal reviews or other recurring audits are handled in a prearranged manner.

b. Working arrangements should be established only upon full mutual concurrence of the contractor and the FAO manager. They should not be permitted to restrict access to records or otherwise limit the audit scope. They should expedite the audit and not become so cumbersome as to cause delays or extra work.

c. Do not sign agreements for local working arrangements. If documentation is necessary, a confirming letter may be issued by the contractor, subject to cancellation or revision at any time upon the auditor's request. Make it clear that the auditor will bypass the arrangements anytime that they impede the audit. Additionally, do not enter into written agreements or affix concurrence signatures to contractor letters containing any access to records provisions. Understandings with contractors on reasonable conditions and procedures for the conduct of an audit shall not prejudice DCAA's access rights to perform audits and shall not be formalized in written agreements signed by DCAA representatives.

d. As a minimum, the resident auditor or resident AIC will hold periodic conferences, usually more than one a year, with the contractor's designated representative at the controller or higher level position. At such conferences, discuss any audit matters that need special management attention and advise the contractor of any changes in audit plans by major audit segment. Document such discussions.

4-303 Interim Conferences**4-303.1 General Procedures for Interim Conferences**

a. Throughout each audit assignment, discuss matters with the contractor as necessary to obtain a full understanding of the [ep basis for each item in the contractor's pricing data or other cost representation, or each aspect of the

functional/operational area under review. Disclose to the contractor any factual duplications, omissions, or other mistakes noted in the contractor's submission, records, or supporting data. As the review progresses, conduct further discussions as needed to gain assurance that audit conclusions will be based on a complete understanding of all pertinent facts. Document all discussions in the working papers, including date, participants' names and titles, and primary discussion points.

b. In the interest of equitable dealings with the contractor and in the proper discharge of official duties, apprise the contractor of any significant understatements noted in price proposals, reimbursement vouchers, or other cost representations when such understatements are clearly the result of obvious and unintentional oversight, bookkeeping or arithmetic errors, etc. Such cases may include mathematical errors in using improvement curve and other computational analysis techniques.

c. If apparent understatements of estimated costs in price proposals or related submissions do not meet the criteria stated above, do not discuss the auditor's conclusions with the contractor unless the negotiating contracting officer so requests. (See 4-304.2.)

d. Handle errors on reimbursement vouchers as set forth in 6-1007e.

e. Communicate major audit problems encountered during review to contractor officials authorized to make a decision. The notification should be made at the earliest possible time. Do not wait until the final exit conference or the issuance of the audit report. Document any oral discussions with appropriate memorandums or notations in the working papers. Major audit problems include:

(1) Denial of access to records, including but not limited to:

(a) Unavailability of contractor personnel,

(b) Failure of contractor personnel to complete audit schedules on a timely basis,

(c) Unreasonable delays by management in permitting the commencement of the audit or in providing needed information.

Follow procedures in 1-504.3 when denial of access is encountered.

(2) Items that impact the reliability of the contractor's books and records, including major internal control weaknesses,

(3) Significant differences concerning the application of generally accepted accounting principles,

(4) Conclusions regarding the reasonableness of estimates used in developing forward pricing/bidding rates,

(5) Any other items that may affect audit performance.

4-303.2 Incurred Cost Submissions

Promptly discuss significant system deficiencies found during performance of incurred cost audits with the contractor. Equally important is the timely notification to the ACO of these deficiencies. Significant deficiencies are those with significant dollar impact on existing or future contracts or which require that the contractor take corrective action(s). Normally discuss the deficiencies during each functional area's (material, labor, indirect expenses, etc.) review.

4-303.3 Functional/Operational Reviews

a. During the review, keep the contractor's designated representative informed of any problems encountered and interim results of completed phases.

b. If contract administration personnel are assisting or participating in the review, fully coordinate interim findings and recommendations with them before discussing deficiencies with the contractor. DFARS Subpart 242.70 joint reviews especially require close coordination to assure team members' consensus and complete understanding of the findings by the contract administration office. Also coordinate with contract administration technical personnel when the findings involve their area of expertise, but their assistance could not be provided during the review. Discussions with the technical personnel in such cases can help clarify and/or support the findings when presented to the contractor.

4-304 Exit Conferences

4-304.1 General Procedures for Exit Conferences

a. Upon completion of the field work on each separate assignment or field visit, hold an exit conference with the contractor's designated representative and summarize the audit results as provided in succeeding paragraphs. Even when there are no questioned or unsupported costs, noncompliances, system deficiencies, or cost avoidance to be reported, the exit conference is a minimum courtesy to the contractor and is an important part of sound contractor relations.

b. Confirm or follow up on requests for the contractor's reaction to any audit exceptions on incurred costs (4-304.4), functional/operational reviews (4-304.5), and CAS adequacy and compliance reviews (4-304.6) for inclusion in the audit report.

c. If applicable (especially on mobile audits), inform the contractor that the audit findings, conclusions, and recommendations are subject to normal DCAA review by the auditor's office before the audit report is issued, and that the contractor will be advised if any significant changes are made.

d. Document the exit conference in the working papers, including date, participants' names and titles, and specifically discussed items and associated contractor's reaction, if any. This provides the information to be included in the audit report, such as required by 10-504.4d.

4-304.2 Price Proposals

a. This category includes contractor proposals to establish (1) initial prices under all types of negotiated contracts; (2) successive target prices and interim prospective prices under FPR- and FPI-type contracts; (3) price changes for contract change orders; (4) other contract price adjustments including those for alleged delay and disruption and requests for extraordinary contractual relief; (5) forward pricing rate agreements; and (6) special or flexible progress payment rates. Treat the incurred cost portion of a final FPR/FPI price redetermination proposal as an incurred cost submission (4-304.4)

¶4-304.2a.

and the projected portion under this paragraph.

b. Do not disclose to the contractor the audit conclusions and recommendations on projected costs or rates that are subject to contracting officer negotiation, except as specifically requested by the negotiating contracting officer. (Discussion of actual cost submissions, even if subject to negotiation, is covered in 4-304.4.) As an example, a labor cost estimate proposed by the contractor may reflect a learning or improvement trend different from the contractor's prior cost experience, with no apparent justification. In this example, you would discuss with the contractor the factual aspects of the prior cost experience and inquire why the experienced trend was not considered appropriate to project future costs. You would not, however, discuss your audit conclusions or disclose the amount of proposed labor costs to be questioned, if any, in the audit report.

c. Discuss with the contractor any discrepancies noted in the cost or pricing data, as defined in FAR 15.801, whether they increase or decrease the contract price. As part of these discussions, and in accord with DFARS 215.805-5(e)(8), inform the contractor of any cost or pricing data found to be inaccurate, incomplete, or noncurrent. Confine the discussions to factual aspects of the data, and do not attempt to influence the contractor to change the proposal. Any changes in the proposal should be based on the contractor's own initiative by formal written submission to the contracting officer.

d. Advise the contractor of any costs to be reported as unsupported (see 10-308.2).

4-304.3 Postaward Reviews of Cost or Pricing Data for Possible Defective Pricing

a. Discuss any factual indication that cost or pricing data may have been defective to afford the contractor an opportunity (normally 30 days) to review the matter and provide any additional information for the auditor's consideration. A draft copy of the report exhibit(s) and accompanying footnotes normally should be provided to the contractor. Final determination as to the existence and extent of defective pricing remains the responsibility of the contracting officer.

b. The contracting officer should also be provided the draft report exhibit(s) and accompanying footnotes normally on apparent defective pricing issues and given the opportunity to provide comments. See 14-122 regarding discussions of the audit findings with the contracting officer. The auditor should discuss the findings throughout the course of the audit rather than only at the end.

c. The contractor may contend that there were understated estimates offsetting any potential price reduction that would result from a contracting officer's defective pricing determination. For contracts entered into on or before 15 February 1987, request specific supporting data for audit review and inclusion in the audit report. For contracts entered into after 15 February 1987, request the contractor provide appropriate certification and specific data supporting the offsets for audit review and inclusion in the audit report (see 14-118 and 10-605.3c).

d. Although the auditor should not expend resources examining uncertified contractor offsets, the auditor should objectively disclose all of the facts known. Therefore, apparent offsets discovered during the postaward audit should be disclosed to the contractor for its analysis and offset submission if the contractor deems appropriate. (Refer to 14-118 for treatment of offsets in the audit position on recommended price adjustments).

e. Coordination and discussion of the findings by all parties before the audit report is issued can minimize delays in the resolution process. Postaward audit reports should not be issued until the initial findings have been properly coordinated.

4-304.4 Incurred Cost Submissions

a. This category includes cost reimbursement vouchers and contractor representations of incurred costs to establish (1) final prices on all types of completed negotiated contracts, (2) final indirect cost rates, and (3) contract termination settlements. Contractor requests for progress payments authorized by the contract

will be treated under this paragraph even though projected costs are involved in the calculations. Proposals to establish special or flexible progress payment rates and interim changes in contract prices are covered in 4-304.2.

b. Discuss all audit conclusions with the contractor's designated official and try to reach agreement on any questions of conformity with generally accepted accounting principles, applicable cost accounting standards, and other cost principles incorporated in the contract(s). If there are audit exceptions to be reported, request the contractor's official reaction for inclusion in the audit report or in the notice of costs suspended or disapproved.

c. See 6-902c and d for special discussion procedures on costs to be suspended or disapproved under cost-reimbursement-type contracts.

d. As discussed in 6-902e, the auditor should notify the ACO of developing issues which may result in the issuance of a DCAA Form 1 as follows:

(1) Provide the ACO with written documentation of the audit results which were discussed with the contractor at the exit conference, unless the contractor immediately agreed to all audit exceptions and the written report will be issued within the next 30 days. The written documentation may be in the form of a memorandum to the ACO, a copy of a memorandum for the file setting forth the results of the exit conference, copies of a draft report exhibit and/or notes, or copies of working paper exhibits and/or supporting working papers. In other words, provide the ACO with whatever information or subset thereof that was provided to the contractor at the exit conference.

(2) Provide the ACO a copy of the contractor's written rebuttal to the audit findings immediately upon receipt.

(3) Discuss significant unresolved issues with the ACO at any mutually agreeable time. Such discussions may result in the introduction of additional data or information which could support or modify audit findings.

(4) The ACO should not ordinarily participate in the formal exit conference. However, if the auditor wishes (or the ACO so requests), the auditor may have

the ACO attend discussions with the contractor subsequent to the formal exit conference, if, in the auditor's opinion, this would facilitate the resolution of contested issues. In arriving at this decision, consider factors such as the likelihood of issuing DCAA Forms 1, ongoing relationships with the ACO, and duplication of effort which may result if joint discussions are not conducted.

4-304.5 Functional/Operational Reviews

a. This paragraph covers reviews of contractor's organizations, functions, and operations for economy and efficiency and financial compliance, including reviews of internal controls, major system surveys, and joint reviews under DFARS Subpart 242.70.

b. After full discussion of each matter requiring contractor action, provide the contractor a draft statement of the condition(s) and recommendations. Carefully design the discussions and drafts to elicit contractor concurrence with recommended system improvements and/or cost avoidance. Request an official written response for inclusion in the audit report, and establish a time frame for the contractor's response. Allow ample time for the contractor to consider the audit presentations, and be receptive to alternatives the contractor may suggest that will satisfy the audit objectives.

c. If the contractor does not agree with the audit recommendations and provides a response, the auditor should provide in the report comments specifically on the contractor's response. If specialist or technical assistance is required in evaluating those alternatives, the auditor should obtain the assistance. Do not merely restate or amplify a position already stated.

d. If the review results in cost avoidance recommendations, make the contractor aware that, effective immediately, any impact of such recommendations will be reflected as questioned costs in reports on price proposal reviews when applicable (in accordance with the criteria in 9-308).

e. See further guidance on discussion of audit findings as part of a team review in 5-1302 (contractor's purchasing system review team), 5-1303 (contractor's insur-

ance/pension review team), and 5-1200 (surveys of contractor estimating systems).

4-304.6 Cost Accounting Standards Reviews

a. This paragraph covers cost accounting standards (CAS) adequacy and compliance reviews and CAS price adjustment impact proposals.

b. Discuss the results of adequacy reviews with the contractor. If one or more disclosures are considered inadequate, solicit the contractor's oral or written reaction for inclusion in the audit report. Do not delay issuing the report, however, if the comments are not provided in sufficient time to permit their inclusion by the established report due date.

c. Thoroughly discuss apparent CAS noncompliances with the contractor to establish that the audit findings are based

on a proper understanding of the issues and that all pertinent facts have been considered. Do not state that the auditor is making a determination of noncompliance, since the contracting officer makes this determination. Because of the significance and complexity of CAS compliance issues, advise the contractor in writing of any instances of apparent noncompliance that will be reported to the ACO. The letter should solicit the contractor's specific comments on the compliance issues and advise that the comments will be included in the audit report if received by a specified date.

d. Before and/or after discussion with the contractor on either an adequacy or compliance review, coordinate the findings with the regional office and the CAC/CHOA/GAC as appropriate (see 8-302.5 & 6). Apprise the ACO of noncompliance matters as soon as practicable (see 8-302.4).

4-400 Section 4 — Audit Working Papers**4-401 Introduction**

This section contains general guidance for the preparation, format, contents, and filing of audit work papers, whether prepared manually or through the use of computers.

4-402 General

a. Audit working papers contain information from accounting and statistical records, personal observations, the results of interviews and inquiries, and other available sources. Audit working papers may also include contract briefs, copies of correspondence, excerpts from corporate minutes, organization charts, copies of written policies and procedures, and other substantiating documentation. The extent and arrangement of working papers files will depend to a large measure on the nature of the audit assignment. For example, an audit of a small terminated contract may result in few working papers; an audit at a major contractor where a resident audit office is maintained may generate a voluminous working papers file.

b. The preparation of working papers assists the auditor in accomplishing the objectives of an audit assignment. Working papers serve as the basis for the conclusions in the audit report; provide a record of the work done for use as substantiating data in negotiations, appeals, and litigations; provide guidance for subsequent examinations; and serve as a basis for the review and evaluation of the work performed.

c. Audit working papers should be prepared at the time audit work is performed and maintained on a current basis. Working papers should reflect the progress of the audit, ensure continuity of audit effort, and permit reassignment of auditors without significant loss of time.

d. Working papers should be relevant to the audit assignment. Files should not include extraneous pages. Superseded working papers should be clearly marked as such and retained.

e. The nature of working papers requires that proper control and adequate safeguards be maintained at all times. Working papers frequently reflect information considered confidential by the contractor, marked "For Official Use Only," or classified for government security purposes.

4-403 Format and Contents of Working Papers**4-403.1 Format of Working Papers**

a. Standardization in type of paper and folders, binding, filing, design, content, and arrangement of work papers is desirable because it facilitates audit, review, and report preparation. A master index of the major series of schedules or analyses should be placed in a prominent position in the working papers file.

b. Conditions and circumstances vary with each examination and it is not practicable to provide uniform instructions as to the material to include in the work papers. This requires the exercise of professional judgment. A constant awareness of the purpose and use to be made of working papers is helpful in determining their content.

4-403.2 Contents of Working Papers

Except as noted below, each working paper should contain the following information:

a. **Heading.** Head each working paper with the name of the contractor, the assignment number and a title or description. In most cases, a good title or description should convey the purpose of the working papers (see 4-403.2.c). When more than one sheet is necessary for any single analysis or schedule, only an assignment number is needed to head pages after the first one. Use appropriate abbreviations when titles and descriptions are long. Position the descriptive headings on the work papers uniformly.

b. **Auditor's Name and Date.** The auditor who prepares or completes a working paper, should place his or her initials and the month, day, and year the work was performed or completed on each sheet. If

the auditor verifies a multiple-page, contractor-prepared document (e.g., bill of material), the auditor should place his or her initials and the date on only the first page of such document. Initials should be identified to the specific auditor in a prominent place in the audit file. It is not necessary for supervisors to indicate their review and approval on each working paper. Supervisory guidance, review, and approval must be evident in the working papers, however. As a minimum, to indicate final review and approval of the work, supervisors should initial and date the lead schedules, the top page of the Summary of Results of Audit section, and the top page of the draft audit report. Initialing these documents is evidence that the working papers have been reviewed to the extent necessary for the supervisor to ensure the audit objectives have been accomplished and there is adequate evidential matter to support the audit findings. In addition, the supervisor must also initial the DCAA Form 7640-20 as an endorsement that the requirements have been met.

c. Purpose. State the purpose on each working paper or the first page of a group of related working papers. The purpose should usually be evident from the contents of the heading of the page (see 4-403.2a). Do not write a duplicative explanation of the purpose when it is clearly evident in the title or heading.

d. Scope of Analysis. Explain the scope of the audit work performed unless apparent. Include appropriate explanatory notes when the scope has been limited, or unusually expanded. Explain each tick mark or symbol used. When uniform tick marks are used throughout the audit, place a legend at the beginning of the file or at the beginning of each applicable section.

e. Source of Information. Identify the source of data or information shown on each working paper. Note that generalized statements, such as "contractor's accounting records," "permanent file," or "John Jones" are not sufficient identification. Sources of information should be explicit (e.g., "contractor's general ledger for CFY 1990" or "oral explanation provided by John Jones, Chief Accountant").

f. Cross-Reference. Cross-reference information or amounts having a direct relationship to other working papers as they are prepared by placing the appropriate reference on each related item. As a minimum, cross-reference the following:

(1) The specific items in the draft of the audit report and the related working papers.

(2) The summary schedules and their supporting working papers.

(3) Interrelated working papers.

(4) The audit program and the working papers (see 3-103d. and f.).

g. Auditor's Conclusions and Recommendations. State the conclusions and recommendations on the working paper as soon as a determination is made. For a group of related working papers, a single conclusion on the first page of the group is acceptable.

h. Indexing. Index each working paper as it is prepared.

4-404 Agenda Sheet

In the course of the assignment, matters may arise which are not settled immediately either because the information is not available or the auditor wishes to avoid interrupting the work at hand. Develop a separate agenda sheet or "To Do" sheet listing matters for further examination as the audit proceeds. Before completion of the audit, review and resolve each item on the agenda sheet. Items which may be placed on the agenda sheet include:

a. Differences to be investigated.

b. Items to be discussed with contractor personnel.

c. Additional audit steps to be performed after preparation of an analysis or schedule.

d. Unavailable contractor records to be examined later.

e. Follow-up on partially completed transactions.

f. Items requiring discussion with or approval of the contracting officer or technical or supervisory personnel.

4-405 Working Papers Files

Working papers are generally classified into two categories: the permanent file

and the current file. General guidance as to the contents of each and their interrelationship is presented below.

4-405.1 Permanent File

a. The permanent file on each contractor is a central repository of information gathered during the course of an audit which has continuing value and use to subsequent audits expected to be performed at the same contractor. Permanent files are useful in preparing the audit program and in determining the appropriate scope of subsequent audits. They also provide ready means for auditors to become familiar with the contractor's operations and any existing audit problems or contractor system weaknesses. While summary information on the contractor's organization, financial structure and policies and procedures may sometimes be included in permanent files for smaller contractors, such information on large contractors with continuing audit activity is generally maintained in the field audit office at a central reference library.

b. The third mandatory annual audit requirement (MAAR) is to maintain and update permanent files for new or changed contractor organizations, operations, policies, procedures, internal controls, and accounting methods that influence the nature, level, and accounting treatment of costs being charged or to be charged to government contracts. The purpose of this mandatory annual audit requirement is to ensure that any of the above type information gleaned from current audit work is summarized or referenced where it is likely to have a continuing value to subsequent audit work. It is not necessary to establish separate audit assignments to gather organizational or procedural manual changes and to file such information in the permanent files when it has no immediate or obvious influence on future audit assignments. In making this distinction between what is needed and all other information, the auditor must be alert and exercise proper judgment. Additional guidance for nonmajor contractors is in G-302; additional guidance for major contractors is in H-302.

c. Following is a list of items which would logically be included in the permanent file as having continuing value in future audit assignments:

- (1) Internal control assessment planning summary sheets.
- (2) Internal control questionnaires.
- (3) MAARs control log.
- (4) Disclosure statement and revisions in accordance with CAS rules and regulations.
- (5) CAS compliance control schedules and a noncompliance summary schedule (through FY 1991).
- (6) FMIS CAS Compliance Testing Report By Contractor (After FY 1991).
- (7) FMIS Noncompliance Testing Report By Contractor (After FY 1991).
- (8) Defective pricing lead sheets.
- (9) Flowcharts, record layouts, and EDP audit reports on accounting systems for government contracts.

d. Maintain the permanent file in a convenient, accessible manner. Include steps in each current audit to identify information of the type described above which should be removed from the current file and placed in the permanent file. Annotate the current audit working papers file to reference any information removed for retention in the permanent file. Auditors using the permanent file in connection with a current audit are also expected to identify permanent file information which is outdated or no longer considered useful for future assignments. Submit recommendations to the supervisory auditor for removal of such data from the permanent file.

e. Auditors often refer to prior current files as frequently as the permanent files. This is especially true with indirect cost audit files that contain audited contract cost information. Accordingly, where the current file contains information that would likely be useful in the performance of future audits and it is not practical to transfer the data to a separate permanent file, maintain and properly reference the current file as part of the permanent file.

4-405.2 Current File

a. The current file usually consists of working papers which have limited use on future assignments. DCAA Forms 7640-19a, b, and c are the Agencywide

4-405.2a.

Working Papers Indexes and provide a concise summary of items generally found in audit working papers.

b. Transfer information contained in the current file to the permanent file if there is anticipated need for the information on other current or future audits.

c. In preparing current file working papers, do not unnecessarily duplicate information located in the permanent file. Frequently the most expeditious method is to reference the permanent file data to the current file.

d. In certain situations a current file may become part or all of the permanent file; see 4-405.1.e and G-302.2.c.

4-406 Copies of Contractor Data

a. When considering the extent of the contractor's data that should be copied and retained in the working papers files, use the following guidelines:

(1) Keep copies of contractor financial records and documents to the minimum necessary to support the information obtained and the conclusions reached. Consider the continuing availability of source documents and contract data retention requirements when deciding whether to reference or reproduce contractor source documents.

(2) Where a particularly sensitive or material audit conclusion hinges on key source documents and referencing would not provide sufficient evidence of the content, include copies in the working papers. This same consideration applies when the audit results can give rise to a government claim against the contractor such as an assertion of defective pricing or an allegation of CAS noncompliance. In these situations, the contractor data should be retained in the working paper files for consideration by the contracting officer in his/her decision making processes. More routine audit conclusions may be sufficiently documented by reference and extraction of pertinent information.

(3) Recognize contractor concerns about reproducing copies of sensitive financial or other operating information. Instead of making copies, take notes or extracts if this will satisfy the government auditing standards and the needs of the

contracting officer can be accomplished with a reasonable expenditure of audit effort.

b. Reasonable access to all records and corroborative documentary evidence necessary to achieve the audit objective must be provided by the contractor. If the auditor is precluded from performing procedures considered necessary and material in the circumstances, including reproducing contractor records and documents, follow the access to records guidance in 1-504.

4-407 Computer-Aided Audit Applications and Working Papers Preparation

a. A computer-aided audit application is any audit task that has been automated using a software program. Any application that is developed must be tested before it is used. The extent and type of testing should be based on the complexity of the application and the inherent risk when relying on the results generated.

b. Audit applications done with a computer must fully satisfy the requirements of 2-306a and 4-402b. Thus, working papers prepared with the aid of a computer should be documented in the same manner as those prepared manually. They should clearly describe the data and procedures employed in the computer application.

c. The amount of documentation will vary depending on the particular computer application employed; however, the data and procedures used in the application must be sufficiently documented and properly retained to satisfy the requirements of 4-402b and to facilitate the recreation of the application. Examples of matters that may need to be documented to fully explain the computer-aided audit work are (1) parts of the computer procedures used that are needed to understand and validate the main output such as formulas used in spreadsheet-type applications or in calculated columns of tabular schedules, (2) detailed schedules supporting summary schedules, and (3) the input data if it is not shown in the output. Depending on the application, the required documentation may be in the

form of supplementary printouts from the computer application program or explanatory annotations by the auditor.

d. Proper training, planning, and testing are important factors in ensuring that computers are effectively used and in minimizing the risk of generating inaccurate results. However, just learning about proper design methods and good construction techniques in developing an audit application provides no guarantee that the results will be error-free. Adequate control features need to be identified, designed, and incorporated into the documentation, data entry, processing, and output portions of an audit application. For example, the following control procedures could be used for spreadsheet applications, where appropriate:

(1) Print a listing of the formulas and relationships.

(2) Attach instructions and identification data with the spreadsheet application.

(3) Create back up files.

(4) Use the lock formulas command to protect formulas and overall structure.

(5) Use record counts, data totals, hash totals, or other control totals.

(6) Calculate key balances using two alternative methods and then compare the results to make sure they are equal.

(7) Use range and reasonableness check numbers to confirm totals.

(8) Run test data and review the output for accuracy.

e. Store the data supporting a computer-aided audit application on reliable computer media (e.g., floppy disk, magnetic tape, etc.) labeled with the appropriate audit assignment number. Take necessary precautions to adequately store and protect the electronic files.

f. Supervisory review to ensure compliance with the auditing standards applies to computer-aided audit applications just as it applies to any other type audit application. The reviewer must evaluate each application based upon its objectives and the relative sensitivity of the audit conclusions.

4-500 Section 5 — Using EDP in Contract Auditing

4-501 Introduction

a. This section describes ways that EDP can assist in review and audit of contract costs being estimated and/or incurred by contractors, and ways available to obtain EDP audit assistance. It includes policy and procedural guidelines for:

- (1) Encouraging contractor applications that ease the contract audit process.
- (2) Using contractor EDP for contract audit purposes.
- (3) Using the DCAA computer system and software for technical audit applications.

b. Sections C-100, C-200, C-300 contain the general background and orientation material on EDP systems and related terminology (including EDP audit trail requirements). More specific guidance on contract audit objectives related to EDP includes:

- (1) Evaluating EDP internal accounting and administrative controls (C-300).
- (2) Determining the acceptability of EDP costs proposed or incurred (7-102, 7-103, 7-200, and C-400).
- (3) Auditing the acceptability of other contract costs processed by EDP systems (C-300).
- (4) Reviewing the economy and efficiency of contractor EDP operations (C-400).
- (5) Performing economy and efficiency reviews of other contractor operations that rely on EDP applications (DCAAP 7641.73).
- (6) Reviewing the design and development of new contractor EDP systems and significant system modifications (C-500).

4-502 Policy on Use of EDP

4-502.1 General Criteria for Using EDP

a. Computers are capable of doing many audit tasks, and DCAA strives to take full advantage of these capabilities. The growing cost and scarcity of auditor time, coupled with increasing economy and efficiency of EDP, make the choice of EDP audit assistance increasingly cost-effective.

b. Using EDP in auditing involves both (1) supplementary processing of data that has been processed by the EDP system and (2) EDP processing of data introduced from non-EDP sources. It also includes obtaining EDP application changes that will ease audit work related to the application (beyond the minimum requirements for internal control).

c. EDP resources usually available to DCAA auditors include any computer system and software from (1) the contractor which has submitted the data, (2) DCAA regional and field audit office, and (3) the Technical Services Center (TSC) (i.e., purchased software or Agency/TSC developed software). If the data is written, copied, unload, or dumped to tape (a sequential or flat file format), it can be accessed by DATATRAK III or any one of a number of other data manipulation software tools. Due to the transportability of data, processing can take place at the contractor site or at any other processing site available to DCAA. Assistance in requesting and obtaining contractor data is available from regional and TSC computer specialists. In some cases, DCAA will also have the option to lease or purchase computer resources and services (commercially or from other government agencies) to meet field audit needs.

d. Documents used to enter information into the computer for processing, certain computer files, or other evidential matter required by the auditor may exist only for a short period or only in computer-readable form. In some computer systems, input documents may not exist at all because information is directly entered into the system. A contractor's data retention policies may require the auditor to request retention of some information for his/her review or to perform audit procedures when the information is available. In addition, certain information generated by the computer for management's internal purposes may be useful in performing analytical tests (e.g., system management facilities and statistical analysis system data).

e. Consider using computer-assisted audit techniques to increase the efficiency of performing audit procedures. Using computer-assisted audit techniques may also provide an opportunity to apply certain procedures to an entire population of accounts or transactions rather than sampling. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

4-502.2 EDP for Mobile and Resident Audits

The most extensive audit usage of EDP, especially the use of contractor EDP, will be at major contractor locations. Mobile auditors, however, should also consider carefully the possible benefits of EDP assistance, especially at locations where there are recurring audits or time-consuming special audit requirements. Furthermore, other resources (such as TSC developed software) are increasingly available for cost-effective use in contract audit assignments performed on a mobile basis (see 4-508).

4-502.3 Use of Contractor EDP

a. With some EDP applications, access to contractor EDP systems and data may be clearly essential for proper audit of costs incurred or proposed. (Audit includes evaluation of internal accounting and administrative controls.) In all other cases, requests for special EDP audit assistance by the contractor should be confined to those which are cost-effective for meeting contract audit requirements.

b. Consider using reports or other records which are otherwise available before requesting special EDP reports. This requires knowledge of the usefulness of available contractor EDP output. When possible, meet audit needs through adjustments to normally scheduled contractor computer runs rather than by special runs solely for contract audit purposes. Be receptive to suggestions of the contractor's systems analysts and programmers, so long as audit objectives are achieved.

c. In many applications the value of the audit benefit received will far exceed the net cost to the contractor. Often minor

added EDP costs are more than justified by benefits accruing to the contractor, such as accelerated cash flow resulting from timely processing of progress payment requests or public vouchers, greater assurance of the accuracy of records, and reduced administrative support to contract audit requirements. Sample selections, cost reconciliations, and special analyses requested by the auditor often save the contractor other significant audit support efforts; and the audit data can often be used by the contractor's operating personnel to improve performance of their assigned tasks.

4-502.4 EDP Cooperation with Internal and Independent Auditors

Obtaining cooperation from the contractor's internal audit staff and/or independent auditors can facilitate the use of EDP in auditing contract costs. These groups normally perform reviews of the company's EDP systems and the data processed thereby. They may often be aware of computer listings and/or general purpose computer programs within the system which will provide the specific information needed by the auditor. Obtain and use this assistance following the guidelines in 4-202 and 4-1000.

4-503 Organizational Support of EDP Audit Applications

DCAA maintains a complete network of FAO, regional, and Headquarters resources to help the field auditor determine the feasibility of EDP audit applications and implement those that are appropriate. (These resources are, for the most part, the same as are available to assist the field auditor plan and/or perform the types of reviews noted in 4-501b.)

4-503.1 FAO EDP Auditors

Where needed, auditors are appointed by FAO managers to serve as focal points for EDP activities within the FAO. These auditors are given specialized EDP training and provide local EDP audit assistance during surveys, evaluations, and audits of contractor EDP systems.

4-503.2 Regional EDP Auditors and Computer Specialists

One or more auditors in the regional special programs offices are responsible for coordinating the overall implementation of EDP policy and programs within the regions. These auditors monitor FAO EDP audit programs and provide technical guidance and assistance in EDP related audit activity. Computer specialists assigned to regional offices provide the same type of EDP guidance and support to the regions as the EDP Branch of the Technical Services Center provides (see 4-503.5).

4-503.3 EDP Training

DCAA's general auditor training and career development plan includes courses designed to provide a basic understanding of EDP and the audit concerns associated with the EDP environment. The courses are offered through the Defense Contract Audit Institute (DCAI). The more specialized EDP courses, offered through both government and nongovernment sources, are available on an as-required basis and are usually provided to FAO and regional EDP auditors.

4-503.4 Computer Assisted Audit Techniques Branch

The Computer Assisted Audit Techniques (CAATS) Branch of the Technical Services Center provides EDP guidance and assistance for computer-assisted audit applications using DCAA DIIS software or similar computer programs. In addition, CAATS is responsible for coordination and control of computer program development to ensure adequate dissemination of new and/or refined computer audit techniques to field offices and to avoid duplicate effort.

4-503.5 EDP Branch

a. The EDP Branch of the Technical Services Center provides EDP technical guidance, support, and assistance in all aspects of mainframe computer related audits including automated information access, retrieval, displaying, and reporting; capacity planning; computer performance evaluation; and system tuning. The EDP Branch also provides direction

and assistance in using generalized data management and data manipulation software packages (both commercially available and TSC developed) such as SAS, TSO/ISPF, IBM Utilities and JCL, ROSCOE, EZ-TRIEVE, File-Aid, DATATRAK, and D-NET. Additionally, this branch will design and write special-purpose mainframe COBAL programs on request.

b. The EDP Branch also coordinates and controls use of the DCAA/TSC mainframe computer system located at the Technical Services Center.

4-503.6 Special Programs Branch

The Special Programs Branch of the Technical Services Center provides guidance and assistance for applications involving E-Z-Quant (DCAAP 7641.91), PC Cost Analyzer (DCAAP 7641.74), Flexible Progress Payments-CASH Model (9-1406), Lease versus Purchase Analysis (LVPA) (7-200), and Financial Accounting Standard Board (FASB) Statement 13 (7-203.1). In addition the branch provides onsite and written directions for complex applications of statistical sampling (Appendix B), correlation analysis (Appendix E), and improvement curves (Appendix F). Also provided is data needed for LVPAs of computer equipment such as residual values, market values, and list prices.

4-504 Generalized Audit Software on Contractor EDP

4-504.1 Overview of Generalized Data Retrieval Software

a. Generalized software can provide a convenient and cost-effective means to select, sort, and list contractor data stored on EDP media, without the need to develop unique computer programs for each data retrieval. The concept of generalized software covers a wide range of generalization-from the broadest-purpose operating system utilities, to specially-designed inquiry programs used only with a single application data base such as one contractor's production control system. Retrieval packages that have been specifically designed for (1) audit applications or (2) contractor-peculiar

data base applications will usually best serve our needs. However, contractors may use either more specialized or more generalized programs to support contract audit requirements for EDP data.

b. As a minimum, audit software packages will permit selection of EDP records randomly as well as by other, nonstatistical decision criteria applied to each record processed. Minimum program features for contract audit needs include stratified sampling and dollar unit sampling (see Appendix B).

c. Some of the more sophisticated EDP audit packages permit selections based on data relationships between successive records and comparisons among data in multiple files. This may include use of data files input by the auditor; for example, using a generalized EDP program to track labor charges to sensitive accounts. As a general rule, including more powerful software capabilities reduces the ease of using the most commonly needed features.

4-504.2 DCAA Data Retrieval on Contractor EDP (DATATRAK)

DATATRAK is a generalized software package which is installed on contractors' systems to retrieve, sort, and summarize large volumes of data. Input data must be in a sequential file format. Specific operational guidance is in DCAAP 7641.89. Information necessary to run the program is supplied by the auditor and input to the program at execution time. Additionally, DATATRAK 3PC is available for use on the microcomputer.

4-504.3 DCAA Computer Performance Evaluation (CPE) on Contractor EDP

System Evaluation Software (SES) is a computer software package developed by DCAA to perform an analysis of a contractor's computer performance data. SES is used to validate contractor provided information. This validation is one of the tools auditors use in the verification of the contractor's system of internal controls. After the package is installed on the contractor's system, performance data tapes are read by SES and reports are generated which assist the auditor in determining the system's level of performance efficiency. Technical assistance by

a computer specialist may be required and can be obtained from the Regional Office or the EDP Branch of the Technical Services Center.

4-504.4 DCAA Netting Evaluation Technique (D-NET)

D-NET is a generalized software package which is installed on a contractor's computer system to analyze and evaluate the appropriateness of the various factors used by the contractor's MRP II/MMAS system to stock, order, cost, assign, transfer, expend, and scrap material resource assets. Parameters required to run the program are supplied by the auditor or computer specialist at program execution time (see 6-308).

4-504.5 Using Non-DCAA Audit Software

a. General-purpose computer programs are commonly used by contractors' internal and independent auditors to sample and analyze electronic data. Such packages are available from computer manufacturers, service companies, and software vendors. A number of public accounting firms, the Internal Revenue Service, and other Federal agencies also have developed or adopted programs oriented specifically toward audit requirements.

b. The contractor may choose to use a program of this type, available on its system, to support contract audit data requirements. This may be appropriate, for example, where a requirement would exceed the capabilities of DATATRAK and other data retrieval software. You may need to consult with an EDP specialist concerning the validity of a particular program and ways to maintain audit control over program execution.

4-505 Exception Analysis on Contractor EDP

a. As a basic feature of both internal accounting control and administrative control, the contractor should routinely use its EDP system to identify any unusual or sensitive transactions and conditions reflected in data being processed. Following the principle of management by exception, some contractors also pro-

14-505a.

gram their EDP systems to identify significant deviations from expected cost and performance results such as standards, production targets, budgets, C/SCSC cost and time milestones, etc. Much of this routine contractor exception data will also serve contract audit requirements.

b. Review available contractor exception data before starting extensive manual audit procedures or designing tailor-made EDP audit programs. Exceptionally large entries, missing document numbers, and credits to cost accounts are a few of the data items which the auditor may need to have identified by the contractor's EDP equipment. Such outputs will normally be readily available as basic records in a well-designed EDP system. If not, make appropriate recommendations for contractor system improvements (14-502).

c. In areas of special government concern, however, it may be appropriate for the contract auditor to obtain output listings and analyses not routinely prepared by the contractor for its own purposes (4-506).

4-506 Special Audit Analyses on Contractor EDP

a. The electronic processing of certain sensitive contract costs may require non-routine computer output for contract audit review purposes. Examples include entries which:

(1) Have been found to include significant amounts of sensitive contract costs.
(2) Have been found to require extended compliance and/or substantive testing as a result of current findings in other audit steps.

(3) Must be accessed for follow-through audit steps such as to compare system output with the results of physical observations or other audit tests (for example, floor checks of specific departments or inventory counts of specific items).

b. As suggested by the examples given, such requirements may be relatively standard from period to period, or may be nonrecurring in details but standard in general form.

c. Where warranted by the frequency of such audit requirements, make local

working arrangements for the contractor to handle them. Regular use of generalized software, including DATATRAK and other data retrieval programs (4-504) and coordination with external and internal auditors (4-502.4), should expedite contractor response to such requirements.

4-507 Computer-Assisted Audit Summarization and Schedule Preparation

A significant portion of required contract audit effort is preparing summary working papers, verifying extensions and footings in contractor cost submissions, and developing audit report exhibits and schedules. There are several software packages available on the DCAA DIIS subsystem which perform spreadsheet analyses, working papers preparation, and word processing.

4-508 Using EDP for Supplemental Analysis

Use of computers in mathematical applications decreases the opportunity for human error and eliminates the time-consuming process of performing the calculations manually, leaving more time available for audit work. Computers can much more efficiently perform the mathematical computations required in evaluating statistical samples, graphic and computational analysis, and improvement curve analysis. DCAAP 7641.91, and Appendixes B, E, and F describe the use of the E-Z-Quant DIIS software programs to perform such tasks as the generation of random numbers within specified ranges, determination of sample sizes, appraisal of sampling results, and fitting of improvement curves and other regression equations to data. In addition, software is available to compute burden allocations, calculate moving averages, appraise work sampling results, and determine the cost effect of lease-vs.-buy decisions.

4-509 Encouraging Contractor EDP Applications to Reduce Contract Audit Impact

a. EDP applications to satisfy audit requirements are in many instances also

useful to the contractor for planning, controlling, and decisionmaking. Therefore, the contractor will frequently write computer programs for its own use or prepare a program for installation on the suggestion of the contract auditor, if the application has internal use or significant benefit to the contractor (see 4-502.3c.). An easily identifiable contractor benefit may be the time saved through a significant reduction in administrative support to the auditors.

b. In other situations, data required by audit may be the normal by-product of a well-designed contractor computer system. In such instances, do not hesitate to make appropriate recommendations for contractor system improvements.

c. Subsequent paragraphs of this section provide examples of contractor EDP applications to reduce the impact of contract auditing.

4-509.1 Reconciliation of Contract Cost Representations to Cost Records

a. Public vouchers, requests for progress payments, contract closing proposals, and related cost statements submitted by contractors do not normally reflect contract costs as recorded in the basic accounting records. Normal reconciling items include both timing differences and permanent differences such as:

(1) Cost exclusions required by contract terms; for example, unallowable costs.

(2) Accrued costs that must be paid before submission for reimbursement, or before inclusion in progress payment requests.

(3) Withholdings, costs in excess of ceilings, etc.

(4) Approved indirect cost billing rates that differ from the contractor's current applied rates.

(5) Costs requiring specific contracting officer approval (may include certain levels or types of purchases, overtime, etc.).

b. A well-designed EDP billing application can save both the contractor and auditor valuable time. Time-consuming and error-prone manual adjustments can be reduced, along with extra work and delays caused by incomplete or unclear reconciliations by contractor personnel.

System objectives, from the contractor's viewpoint, may include:

(1) To increase control over the accuracy and completeness of government contract cost billings and related general ledger accounts. This includes optimal billings of contract withholdings.

(2) To reduce manual billing effort, including time spent resolving questions with government representatives.

(3) To accelerate the billing cycle, possibly improving cash flow if delayed billings are a factor.

(4) To simplify preparation of final contract cost statement reconciliations.

c. Key features of an effective EDP billing system are outlined below. (The description is oriented toward separate file processing, but the features can also be incorporated into an integrated cost accounting data base system.)

(1) For each billing period, the appropriate summary of direct cost input by billable order is automatically posted from cost ledger input files to the billing ledger file. (The term "order" includes a contract or subcontract, or separate task orders, etc., which must be billed separately.) At this point, any potentially nonbillable direct costs should, when possible, be automatically coded as such in the billing ledger data based on programmed criteria applied to cost ledger source codes. This would include unpaid accrued costs, and costs subject to special approval requirements or other contract limits.

(2) The billing system also provides for input to segregate any nonbillable direct costs that cannot be identified by the program and to move costs to the billable category when/if required conditions have been met. For example, another input may be needed when subcontract accruals have been paid. Billing ceilings, withholding requirements, etc., are also input and used to control total cumulative billings by order.

(3) Billable and nonbillable direct cost input is separately accumulated by indirect cost base by fiscal year, for each order. "Non-burden-bearing" and/or "special-burden-bearing" costs fall into one or more separate categories by fiscal year by order.

4-509.1c.

(4) Two sets of indirect cost rates by fiscal year (currently applied in cost ledgers and currently billable) are input to the billing system whenever they change. The system applies billable indirect rates to appropriate base costs to provide current billable costs by order. The effects of base and rate adjustments for each year are separately identified.

(5) The system records billings actually submitted so current net billable costs by order are always known. Negative balances produce automatic credit billings or other needed exception output. (The contractor may also choose to track the receipt of contract payments in the same system.)

(6) With the data available, the system can readily provide any needed reconciliations and exception reports by order, by fiscal year, and at the total system control level. Final contract cost statement reconciliations may also be produced automatically.

4-509.2 Segregation and Control of Data Rejections, Corrections, and Adjustments

a. Sound accounting control over contract costs should include procedures to identify and appraise the nature and extent of data rejected by the EDP edits, and adjustments and corrections made to data processed through the EDP system. Continuous review should ensure that all

rejected data is promptly reintroduced and that adjustments and corrections are adequately supported and authorized. A well-designed EDP system with built-in controls over rejected data, adjustments, and corrections can save time for both the contractor and DCAA.

b. One sound technique for sensitive data files is to have the EDP system date and serially number each rejected transaction, store a copy in a suspense file, and automatically track that each one is re-submitted. With a suspense file system, internal control listings can compare rejected and resubmitted entries. Periodic exception reports should flag excessive time lags in processing corrections and specific departments or cost areas that cause excessive rejections.

c. Some contractor systems intermingle normal EDP input entries with corrections and adjustments. Such a system design creates a large and unnecessary burden for other internal control and audit procedures. The computer can be used to segregate adjustments and corrections quite easily through use of separate identification codes in the transaction entries. Appropriate programs can then make needed analyses of all transactions that alter data previously processed. Also, special exception reports can readily alert management and internal auditors to unusual cost adjustment activity.

4-600 Section 6 - Audit Sampling**4-601 Introduction**

This section states the procedures for audit sampling on a judgmental or statistical basis. Detailed guidance is in Appendix B, Statistical Sampling Techniques.

4-602 Sampling

Audit sampling can be classified into the two main categories of estimation and acceptance sampling. The sampling method used depends on desired audit objectives.

a. Estimation sampling provides an answer to the question of either how many or how much, and can be further classified into sampling for attributes and sampling for variables. The purpose of attributes estimation sampling is to estimate the frequency with which items fall into certain categories (how many), such as compliance with internal controls. The purpose of variables estimation sampling is to provide an estimate of average or total value (how much), such as the total questioned amount in a bill of materials. Estimation sampling provides a point estimate of the actual frequency (in attributes sampling) or value (in variables sampling) that exists in the universe or stratum. It also enables the auditor to assess the sample's reliability, or how much reliance to place on the point estimate. This feature, consisting of an estimate of the sampling error, shows how far the point estimate might be from the value obtainable from total review.

b. Acceptance sampling, which can also be subdivided into attributes or variables sampling, differs from estimation sampling in that its purpose is simply to either accept or reject a statement of condition. In this case, consideration of sampling error is incorporated in the acceptance criteria. Acceptance sampling is not intended to provide information regarding how good or bad a statement or representation might be.

c. Throughout this manual the auditor is advised to "test check" a procedure, to make verifications "on a selective basis"

or to review a "representative number" of transactions or items. These instructions recognize that a complete review of all the transactions which support a proposal, claim, or other form of financial representation generally is unnecessary or impractical. Review of all representations may be required when a few transactions or items of large amounts are involved or when it is necessary to develop detailed information devoid of sampling error, such as in the case of support for legal action. In most instances, however, it is possible to support a professional opinion regarding a contractor's representation by reviewing a limited number of transactions on a sampling basis.

d. It is usually more efficient to group or stratify items to be tested into two or more categories, one group or stratum to be reviewed in its entirety and the remaining groups or strata to be reviewed on a sampling basis. When an item has been selected for review, the review must be completed, regardless of difficulty, to provide statistical integrity of sample results. When initial examinations disclose excessive misrepresentations or frequency of error, it may be appropriate to discontinue the review, abandon statistical interpretation of sample results, and issue an opinion on the basis of the strength of the evidence provided by the initial sample items. In the case of acceptance sampling, the auditor might develop a sampling plan that provides for curtailment of sampling when no significant error appears in a preliminary sample, as explained in the material on the use of preliminary samples in Appendix B.

4-603 Scope and Degree of Testing

The scope and degree of testing is a matter of judgment by the auditor. The decision will be influenced by prior experience, materiality, sensitivity, and other factors, including recognition of the important factor that only a statistical sample can be defended as truly objective. In selecting the items to be tested, and in determining the extent of the examina-

tion, the following guidelines should be considered:

(a) All large transactions should be considered for examination (the meaning of "large" will vary; thus, a \$1,000 item in a \$10,000 claim would deserve attention, but the same item would not be "large" in a \$10 million indirect cost pool in which the government shares a small percentage).

(b) All transactions of an unusual or sensitive nature should be reviewed.

(c) More extensive tests may be necessary in areas where procedures or internal controls are known to be weak or where deficiencies were disclosed in previous audits, where errors or items of a questionable nature are more likely to occur in certain departments or in records produced by certain categories of employees, during certain periods of reorganization, or where personnel are assigned unfamiliar tasks.

(d) The lapse of time since previous tests should be considered.

(e) Special attention should be given to those areas where incorrect charges would have the greatest effect on the costs to the government.

(f) Trend information from previous audits should be considered.

(g) Other transactions should be tested where the total amount may be significant in the aggregate.

4-604 Method of Selecting Sample Items

a. The method of selecting the sample items affects the interpretation of the results. The results of a randomly selected sample can be objectively applied to the stratum from which the sample is drawn because the sample items are drawn without regard for their possible outcome upon review. Judgmentally selected samples lack this feature because it cannot be indisputably demonstrated that some items in the strata are not favored for selection over others on the basis of their possible outcomes. Furthermore, only with random sample selection can the reliability of the sample results be determined.

b. A randomly selected sample, often referred to as a statistical sample because

statistical principles can be applied to it, is one in which each item in a stratum has an equal probability (or chance) of being selected. More broadly, a statistical sample is one which each item in the stratum has a determinable chance of being selected. The manner of selection of the items must preclude any personal influence as to which items are included in the sample. Judgment and knowledge of the subject area, however, are necessary in defining the sampling unit and what constitutes an error or deficiency, in deciding where to stratify, and in designing the sampling plan. There is no limit on the amount of judgment that is used, provided it is not allowed to influence the selection of sample items. Random sample selection procedures are discussed in Appendix B.

c. Statistical sampling for variables (estimation sampling) can be performed in two ways, depending on designation of the sampling unit. With physical unit sampling, each item (physical unit) in a stratum has an equal chance of being selected. With dollar unit sampling (DUS), each dollar in the stratum has an equal chance of selection. Dollar unit sampling is sometimes referred to as probability proportionate to size (PPS) sampling because, although each dollar has an equal chance of selection, the physical units containing the sampling (dollar) units have a probability of selection that is proportional to their size. Except for the option of a stratum for total review, the need for stratification based on physical unit magnitudes is eliminated in DUS. The appropriate use of these two methods is discussed in Appendix B.

d. A judgmental sample is one in which individual judgment has influenced the selection of sample items. Although judgmental sampling results cannot be used to make totally objective inferences regarding conditions of the entire stratum or universe, they might be adequate in some circumstances to form an audit opinion. For example, if a judgmental sample reveals a high degree of inaccuracy in a price proposal, the entire proposal may be rejected. Although a judgmental sample may be acceptable, there is no way of estimating the reliability of the

results or guaranteeing their objectivity. Such qualities are available only through statistical sampling or total review of the stratum or universe.

4-605 Sampling Policy

a. Because of its many advantages, including objectivity and overall defensibility, statistical (probability) sampling will be used, if feasible, wherever an audit involves tests or selected transactions or items in order to express an opinion regarding the entire area (universe) from which the selection was made. If statistical sampling is not used in these circumstances, an explanation should be given in the working papers.

b. Where statistical sampling methods are used, the report may include a statement to that effect. In expressing an opinion as to the results of sampling for variables (estimation sampling), only one projected value or amount will be used, that single amount (point estimate) having been developed from the sample results by either the difference (or mean) method or the ratio method as discussed in Appendix B. No comments will be made as to confidence level (assurance) or confidence interval (tolerance). These comments and supporting data and computations will, however, be included in working papers.

c. For audit purposes, items stratified for detailed or more intensive examination will not be considered a part of the sample area (universe); hence, the results will be appraised separately from the statistical evaluation of the sample result.

d. Where appropriate, the statistical sample result should be projected to the universe from which the sample was selected.

e. Computer systems will be used to the maximum in the stratification, random selection of sample items, and statistical evaluation of sample results. See 4-606 for a description of sampling software.

f. The use of statistical sampling methods should be discussed in advance with statisticians or other appropriate personnel of the contractor wherever possible. The purpose of these discussions is to establish, in advance, mutual acceptance of the sampling procedures; however, no prior commitment should be made regarding sample reliability.

4-606 Sampling Software

There are a number of computer software packages available to assist the auditor in data retrieval and in stratifying, selecting, and appraising the results of a sample.

a. DATATRAK is a generalized software package that is installed on contractors' systems to retrieve, sort, and summarize large volumes of data. Specific operational guidance is in DCAAP 7641.89. Information necessary to run the program is supplied by the auditor and input to the program at execution time.

b. The Electronic Selection Program (ESP) is a microcomputer software package that has multiple capabilities including dollar unit sampling. At certain contractor locations involved in the EDP expansion program, the Integrated Audit Workstation (IAW) is available to expand mainframe-to-microcomputer data retrieval and analysis capabilities. When used in conjunction with the IAW data retrieval functions, ESP software can export and import data files so that supporting mainframe-based data can be retrieved for dollar unit sampling and audit report schedule preparation.

c. E-Z-Quant is a collection of quantitative methods for which software has been written for use on microcomputers to perform quantitative analyses such as statistical sampling, correlation analysis, and improvement curves. Specific operational guidance is in DCAAP 7641.91.

4-700 Section 7 — Responsibilities for Prevention, Detection, and Reporting Fraud, Other Unlawful Activity, or Improper Practices

4-701 Introduction

This section covers procedures, audit guidance, and responsibilities relating to fraud, other unlawful activity, anticompetitive practices, and voluntary disclosures.

4-702 Suspected Fraud and Unlawful Activity — General

4-702.1 General

a. When auditing a contractor's records in accordance with government auditing standards, auditors may encounter, or receive from other sources, information constituting evidence or causing suspicion of fraud or other unlawful activity. (Examples of other unlawful activity include violations of the Anti-Kickback Act, anticompetitive (antitrust) practices, and illegal political contributions). Sources for such information may include company employees, disgruntled participants, or others making allegations by letter, telephone, personal visit, or through a third party. Such information may pertain to acts of:

(1) military personnel or civilian employees of the government in their relations with the government.

(2) military personnel or civilian employees of the government in their relations with individuals or firms.

(3) individuals or firms in their business relations with the government.

(4) individuals or firms in their business relations with other individuals or firms doing business with the government.

b. Definition. For purposes of this chapter, the term "fraud" or "other unlawful activity" means any willful or conscious wrongdoing, including, but not limited to, acts of cheating or dishonesty which contribute to a loss or injury to the government. Some examples are: (1) falsification of documents such as time cards or purchase orders; (2) charging personal expenses to government contracts; (3) submitting false claims such as invoices for services not performed or

materials not delivered; (4) intentional mischarging or misallocation of costs; (5) deceit by suppression of the truth; (6) bribery; (7) corrupt payments which violate the Foreign Corrupt Practices Act; (8) theft; (9) a government employee acquiring a financial interest in or seeking employment with a contractor over whom the employee exercises oversight; (10) kickbacks; (11) any unlawful or fraudulent acts resulting from accounting classification practices designed to conceal the true nature of expenses, e.g., classifying unallowable advertising or entertainment costs as office supplies; (12) product substitution or false certification that tests were performed; and (13) any attempt or conspiracy to engage in, or use, the above devices.

4-702.2 Auditor Responsibilities for Detecting and Reporting Fraud

a. In determining contractor compliance with laws and regulations, government auditing standards require auditors to design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, or illegal acts that could (1) have a direct (or indirect) and material effect on contractor financial representations or the results of financial-related audits or (2) significantly affect the audit objectives. Auditors should also exercise (1) due care in planning, performing, and evaluating the results of audit procedures and (2) a proper degree of professional skepticism to achieve reasonable assurance that material unlawful activities or improper practices are detected. Under the concept of professional skepticism, an auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, an auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine if contractor financial representations are free of material misstatements. Many aspects of a DCAA auditor's responsibilities, particularly as set forth in Chapters 6 and 9, require con-

stant alertness to the possibility of fraudulent activities. This alertness, combined with a contractor's internal controls and the auditor's normally programmed tests of procedures and transactions, should provide a reasonable degree of assurance for disclosing fraud or other unlawful activity. (See also 4-702.3.)

b. Auditors are not trained to conduct investigations of illegal acts. This is the responsibility of investigators or law enforcement authorities. Auditors are responsible for being aware of fraud indicators, vulnerabilities, and potentially illegal expenditures and acts associated with an audit area (see 4-702.3a. and b.). When an auditor obtains information that raises a reasonable suspicion of fraud or other unlawful activity that has not been previously disclosed to the government, an investigative referral should be initiated (see 4-702.4). (However, if such information relates to a contractor's voluntary disclosure, see 4-707.)

c. Issuance of an investigative referral should not be deferred until completion of the audit. Neither should it necessarily take place as soon as the auditor is confronted with a fraud indicator. The auditor should follow up the indicators through audit until he or she is satisfied either that no innocent explanation of the irregularity is plausible or that no further relevant information can be generated through audit techniques. This is similar to the manner in which a tentative decision to question costs would be followed up. The auditor must avoid the appearance of conducting an investigation. If the auditor is in doubt about the propriety of a proposed audit step, guidance should be requested from the supervisor or FAO manager. Audit support to investigations is covered in 4-702.6 and 4-702.7.

d. The following guidance applies when suspected irregularities are discovered by either government or contractor auditors during joint audits. Joint audits are discussed in 4-202.1d.

(1) As soon as there is a discovery of a suspected irregularity during the conduct of a joint audit, both the government and contractor participants in the audit should be notified. The contractor will

have 30 days from the date of the discovery to make a voluntary disclosure to the DoD Inspector General. The disclosure must be made in accordance with the requirements of the Voluntary Disclosure Program as described in 4-707.

(2) Audit tasks from the joint audit plan pertaining to the suspected irregularity will normally be suspended until the 30-day time period has elapsed, or until the contractor notifies the government it does not intend to make a voluntary disclosure. Upon such notice, audit activities in the area will be subject to CAM 4-702.4 procedures for determining whether a referral is required. Work on other tasks in the joint audit plan may continue.

(3) If the contractor makes a voluntary disclosure and is accepted into the Voluntary Disclosure Program by the DoD Inspector General, it will be permitted to conduct an independent internal investigation of the suspected irregularity, in accordance with the provisions of the Voluntary Disclosure Program. Audit tasks from the joint audit plan pertaining to the disclosure will be suspended until that investigation is completed.

e. Suspected irregularities, whether discovered through audit steps and procedures; discovered by an auditor inadvertently, as in a conversation overheard; or disclosed to an auditor, either in person or through an anonymous tip, shall be recorded in the audit working papers and reported promptly to FAO management. It is not necessary to establish that the government has been defrauded before alerting investigators. Proving that an unlawful act has occurred is the responsibility of investigators and prosecutors.

4-702.3 Fraud Indicators and Audit Procedures for Uncovering Fraud

a. Auditors should be familiar with specific fraud indicators. DCAA self-study course No. 1280, "Fraud Prevention and Detection," contains several case studies on fraud detection and a discussion of fraud indicators. Following are publications issued by the DoD Office of the Inspector General (DoD IG) providing additional guidance:

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(1) Handbook on Fraud Indicators for Contract Auditors (IGDH 7600.3, APO, March 31, 1993)

(2) Indicators of Fraud in DoD Procurement (IG, DoD 4075.1-H, June 1987)

(3) Criminal Defective Pricing and the Truth in Negotiations Act (IGDPH 4200.50, CIPO, March 1988)

(4) Role of the Contract Auditor in Criminal Investigations (IGDH 7600.2, January 1989)

b. Effective audit risk assessments and audits of internal controls are useful procedures for assessing risk of fraud against the government. Proper execution of audit programs together with adequate tests of contractor internal control systems should provide reasonable assurance that significant fraudulent and other unlawful practices are detected (see Chapters 5, 6, 7, and Appendix C).

In addition to the indicators shown in Figure 4-7-3, specific fraud indicators, risk factors, audit tests, and procedures for the detection of fraud appear in the standard audit programs and in the listed CAM sections for the following audit areas:

Audit Area	CAM Reference
Internal Control Reviews	5-100
Physical Observations	5-108a
Accounting for Material Cost	6-305
Storing and Issuing Materials	6-312
Labor Cost Charging and Allocation	6-404.6
Floor Checks	6-405.2/.3
Overtime	6-409.2
Consultant Costs	7-1905.1
Defective Pricing Audits	14-121
EDP System Reviews	5-400

c. Treat as a possible audit lead any allegation received from outside sources, such as telephone calls, anonymous letters, and contractor employees. If there is further evidence available at the FAO to support the allegation and a reasonable basis to suspect fraud or other unlawful conduct, report the suspicions in accordance with 4-702.4. If the allegation provides a reasonable basis to suspect fraud or other unlawful conduct, but

there is no further corroborating evidence, relay the allegation using the DoD Hotline (4-702.4a(1)). A contractor's voluntary disclosure will not normally be treated as a potential fraud referral (see 4-707).

4-702.4 Procedures for Referring Suspicions

a. Upon encountering or receiving information which raises a reasonable suspicion of fraud, corruption, or unlawful activity (see 4-702.3) relating to a government contract:

(1) Promptly prepare a DCAA Suspected Irregularity Referral Form (DCAAF 2000.0), or utilize the DoD Hotline toll-free telephone number (800/424-9098) or the mailing address (Defense Hotline, The Pentagon, Washington, DC 20301-1900). If the irregularity does not affect DoD contracts, the matter may be reported to the inspector general of the agency most at risk.

Use of the DCAAF 2000.0 is the preferred method for forwarding this information. It specifies the information needed by investigators and provides for appropriate consideration of audit impact. A copy of the DCAAF 2000.0 is included as Figure 4-7-2. The DCAAF 2000.0 is also available on the FAO DIIS.

(2) If the DCAAF 2000.0 is to be used, it should be obtained from the FAO DIIS, completed, and submitted to your immediate supervisor. Fully describe the fraudulent condition to be reported and reference the procurement regulations or statutes that were allegedly violated. Include information on contractor efforts to hinder or obstruct audit work which uncovered the suspected fraud (see 4-708).

(3) Care should be taken to avoid unnecessary use of legal terminology or proliferation of enclosures beyond those necessary to explain the problem. The purpose of the DCAAF 2000.0 is to alert an investigator to a possible irregularity, not to establish that the reported irregularity is a violation of the law. The auditor's obligation to protect the contractor's records from unauthorized access requires that the distribution of documents which appear to provide evidence of impropriety be restricted. Evi-

dentiary material should be made available to the investigator at the earliest opportunity after an investigation has been opened, preferably during the investigator's initial visit to the FAO.

(4) Place an initialled and dated copy of the draft DCAAF 2000.0 in the audit working papers to establish a record of events leading up to the decision to make a referral.

(5) Continue with assigned duties and pursue development of factual information as appropriate or indicated by 4-702.5. Coordinate any continuing review with your supervisor or FAO manager.

b. Instructions for referring suspicions are contained in the DCAA Instruction on "Reporting Suspected Contractor Fraud and Other Contractor Irregularities" (DCAAI 7640.16).

4-702.5 Audit Activities Subsequent to Referral — Continuing Audits

a. Following a referral, or after notification of the initiation of an investigation, take no actions that would compromise the investigation. Do not attempt to establish wrongdoing (an investigative responsibility) nor inform the contractor that a fraud referral has been made. Audit scope may, after consultation with the investigative organization, be expanded to determine the impact of the suspected fraud or other unlawful activity on audit objectives. Do not expand audit scope for the sole purpose of gathering additional information to support an investigation. If audit activities relate to an area under investigation or litigation, coordinate with the cognizant investigative or prosecutive organization before taking any final administrative action. An example of such an audit activity is the issuance of final audit-determined indirect cost rates. Audit activities outside the area of investigative interest will continue unless the investigative organization requests in writing they be deferred or suspended. If it is believed the requested deferral will cause financial harm to the government or unnecessarily impede the audit mission, elevate the matter for management resolution between the respective organizations. Before any decision is made to defer or

suspend an audit, coordinate the matter with Headquarters (OPD).

b. Furnish a copy of any resulting audit report (see 4-702.5d. and 4-702.6h.) to the appropriate investigative organization. Also, furnish any information developed later, relating to the suspected wrongdoing or similar misconduct, directly to the responsible investigative agency without filing a separate DCAAF 2000.0. Reference all future correspondence and/or updates with the DCAA case number assigned by OPD, and, if available, the case control number assigned by the investigative agency. In order that current, complete, and accurate information is available to the Defense Procurement Fraud Unit (DPFU), furnish the DCAA Justice Liaison Auditor (JLA), DCAA's representative to the DPFU, a copy of all unclassified audit reports or memorandums prepared in support of an investigation, voluntary disclosure, or similar demand assignment. The address is:

DCAA Justice Liaison Auditor
U.S. Department of Justice
Defense Procurement Fraud Unit
Bond Building, Room 3100A
P.O. Box 28188, Central Station
Washington, DC 20038

c. Suspicions of fraud or other unlawful activity may be so serious as to prevent the issuance of an unqualified audit report or lead to a recommendation that contract payments be halted pending resolution. If additional time is required to develop factual information for an audit impact determination, the final audit report can usually be delayed for DCAA-initiated assignments. (See 4-702.5a. and

e. before issuing a report.) Examples of such assignments are operations audits, estimating system surveys, or postaward audits. However, when an audit report is scheduled for issuance within a specified time frame (e.g., a report on a price proposal audit) the suspected condition may have a serious impact on the auditor's ability to meet the due date. When this occurs:

(1) Consult the regional office.

(2) Contact the Plant Representative/ACO or the representative of a non-DoD agency, as appropriate, to explain

¶4-702.5c.

the condition and arrange for an extended report due date. Do not do this, however, if the contracting representative may be involved in the suspected unlawful activity.

(3) Qualify the report if a due date cannot be extended, and inform the requester by separate letter of the circumstances affecting the situation (but see 4-702.5a. and e.).

(4) Question any costs improperly claimed as a result of the suspected wrongdoing (but see 4-702.5a. and e.).

d. Carefully protect and strictly control all information related to the suspicion of fraud or other unlawful activity. This is to protect the reputations of innocent persons and ensure that information is not prematurely or inadvertently disclosed to persons suspected of wrongdoing. Premature or inadvertent disclosure could compromise the government's efforts to gather needed evidence. Mark all related DCAA reports and correspondence "FOR OFFICIAL USE ONLY" (unless a security classification is required). Control and protect all such information as follows:

(1) During normal duty hours, keep the documents in an out-of-sight location if the work area is accessible to nongovernment personnel (e.g., contractor personnel).

(2) After duty hours, place the documents in locked receptacles such as file cabinets, desks, or bookcases.

(3) When such information is being disseminated outside DCAA, hand carry reports and correspondence between appropriate officials whenever practicable, or otherwise transmit them in a manner which will prevent inadvertent release to unauthorized persons.

e. Do not issue an audit report on any part of a representation containing a fraudulent claim without first notifying and coordinating with the cognizant investigative agency (see 4-702.5a). Normally there is no need to withhold an audit report unless it can be demonstrated that its issuance would hinder an investigation or prosecution. Before a decision is made to withhold an audit report, the FAO or region should coordinate the matter with Headquarters (OPD). Unless otherwise instructed, send

the original audit report to the responsible contracting officer/ACO along with a separate cautionary transmittal memorandum regarding the suspected unlawful activity. See Figure 4-7-1 for an example. Do not make reference in the audit report to suspected irregular conduct or a referral for investigation, and do not send copies of the transmittal memorandum to other parties. In circumstances where government contracting representatives may be involved in the suspected unlawful activity, do not use the transmittal memorandum if, per discussion with the cognizant investigative agency, the information contained therein would interfere with a pending investigation.

f. It is DCAA policy that information relating to a matter referred for investigation will be protected and not released or disclosed to a contractor, or a contractor's employee, representative, or attorney. This policy is based on the need to avoid the disclosure of information which might impede or compromise an investigation. A regional director or head of a principal staff element may make a case-by-case exception to this policy after consultation with the cognizant investigator and OPD.

g. Representatives of a contractor seeking protected information might take unusual measures to contact the auditor away from the workplace. Such measures could include telephoning or making an unannounced visit to the auditor's home. Whether the contact occurs at the workplace or elsewhere, do not discuss any aspect of a matter referred for investigation. Any contractor contacts, whether related to an investigation or normal audit activity, should occur at the auditor's or contractor's place of business during normal duty hours. If an attempt to contact the auditor outside normal working hours or workplace occurs, notify the region, OPD, and the cognizant investigative organization.

4-702.6 Investigative Support Responsibilities

The auditor's responsibility for detecting fraud ends with the submission of a Form 2000.0 Hotline referral. DoD IG Joint Policy Memorandum No. 2 (JPM-2), which is enclosure 1 to DCAA Regula-

tion (DCAAR) 7640.15, makes the investigative agency responsible for directing, monitoring, and reporting on the status of fraud investigations. Audit support to DoD investigative organizations is authorized by DoD Directive 7600.2, "Audit Policies," dated 2 February 1991. Specific guidelines concerning audit support of fraud investigations are contained in JPM-2. The provisions of JPM-2 were carefully developed to encourage cooperation between DoD investigators and auditors, and to clearly define the responsibilities of each organization. Offices furnishing support to investigative activities should be thoroughly familiar with the contents of this memorandum. Following are some of the regional, FAO, and auditor investigative support responsibilities:

a. Regions are to establish procedures, documented by regional instructions, which provide for regional oversight of the timeliness and quality of audit support to investigators.

b. Auditors should support formally constituted investigations when the investigators have submitted a written request for assistance to the cognizant FAO. Auditors will treat requests for investigative support as demand assignments and schedule them for completion on that basis. Such requests should include a list of the audit tasks needed to support the investigation. If requested, the FAO will assist the investigative organization in framing the list of audit tasks being requested. This list may be amended periodically, depending on investigative developments or as deemed necessary by the auditor to properly fulfill his or her mission or function. A formally constituted investigation is one which (1) has progressed beyond the preliminary inquiry stage, (2) has been assigned an investigative case number, and (3) has resolved all issues regarding notification of the contractor under investigation. It is the investigator's responsibility to notify the contractor that it is under investigation and that DCAA auditors are assisting. This should be done before DCAA provides support to a criminal investigation requiring access to contractor records or personnel.

c. Auditors will provide prompt and effective support to investigators consistent with the auditor's role in the acquisition process. Auditors assigned to assist investigators will remain under the operational control and supervision of DCAA management. Auditors are not to perform clerical or other tasks outside the normal function of the auditing profession on behalf of investigators and are not to assume the role of an investigator.

(1) Auditors assigned to support an investigation are not required to meet contractor employees or other witnesses in situations where their safety may be threatened. If such unsafe conditions are expected, auditors may be asked to develop questions, but are not required to accompany the investigator. Requests for the use of DCAA resources to assist covert or clandestine investigations or operations must be elevated to DCAA Headquarters, Attn: OPD.

(2) Investigators have authority (through inspector general or grand jury subpoenas and search warrants) to obtain documents not normally available to DCAA in performing its mission. When assigned to support an investigation, auditors will not have investigators use their authority to obtain, for DCAA's use, information or documents not related to the investigation. Conversely, auditors will not use DCAA's authority to obtain for investigators information or documents not related to the investigation.

(3) Auditors assigned to a criminal investigative team will not, directly or indirectly, state or indicate that their presence at the auditee's premises is for any purpose other than to assist in a criminal investigation. To do otherwise could result in audit-obtained information being deemed inadmissible in court.

(4) When supporting an investigation, it may be necessary to audit companies that are not the target of the investigation. An example is the audit of a subcontractor to confirm or refute information provided by a prime contractor. If a company is not the target of an investigation, do not inform the company of the investigation or of the investigative nature of the audit.

¶4-702.6d.

d. Auditors will (1) provide government investigators and prosecutors ready access to applicable DCAA working paper files, including contractor-generated material contained therein, (2) list in the working papers or DCAAF 2000.0 file copies of working papers and other data provided to investigators, and (3) document in the working papers or DCAAF 2000.0 file meetings with members of governmental investigative agencies (see 1-406). See 4-702.5c., d., e., f., and g. for guidance on the protection of information relating to investigations.

e. If, within the course of exercising its existing authority, DCAA obtains custody and control of original documents (including contractor records) reflecting indicators of fraud or other unlawful activity, DCAA must immediately inform the cognizant criminal investigative organization so appropriate measures can be taken for the government to maintain custody and control over such documents.

f. Grand jury proceedings are criminal investigations officially conducted by the Department of Justice or an assistant U.S. attorney (AUSA) rather than a DoD investigative organization. An AUSA or DOJ attorney may also conduct a civil investigation into suspected contract fraud. In many cases, the trial attorney obtains services from an investigative agency such as the FBI. The investigator will then obtain DCAA audit assistance. Although JPM-2 does not address DOJ trial attorneys, AUSAs or the FBI, it is DCAA policy that the obligations of the requester and auditor are the same as those specified in JPM-2.

g. Audit services to non-DoD agencies are furnished under cross-servicing agreements which provide for interagency billings. None of these agreements specifically provides for investigative support services. To ensure consistency, handle requests from non-DoD agencies for investigative support using the guidelines in JPM-2. Investigative support to non-DoD agencies other than the Department of Justice (DOJ) and the FBI is reimbursable, and this should be confirmed with the requesting agency before such services are rendered. Investigative support to DOJ and the FBI is reimbursable only

to the extent that DOJ or FBI contracts are affected.

h. Typically, audit support of investigations consists of completing routine overhead audits or defective pricing audits of special interest to investigators. In these situations, report audit results using standard audit reports (see 4-702.5e., 4-702.8, and Chapter 10). However, certain requests for investigative support require effort not fitting the pattern of established audits. In these circumstances, consider the information needs of the requester in conjunction with the guidance in 10-1200 when issuing reports in response to investigative support requests. Do not release results of these audits, including draft condition statements or recommendations, to the contractor before consulting with and obtaining the approval of the investigator. Discuss factual matters with the contractor only to the extent necessary to ensure accuracy. These procedures are necessary to prevent premature release of audit results which could compromise government actions regarding the condition under investigation.

4-702.7 Control of Documents Obtained Under Inspector General or Grand Jury Subpoenas and Civil Investigative Demands

For criminal investigative purposes, documents may be obtained under either an Inspector General (IG) or a grand jury subpoena. The civil investigative equivalent of a grand jury subpoena is referred to as a civil investigative demand (CID). DCAA subpoenas will not be used in connection with investigations. When an investigative office obtains documents under an IG subpoena, it is the custodian of the documents. When the documents are obtained under a grand jury subpoena, the grand jury is the custodian and the government prosecutor or the investigator acts as the grand jury's agent or representative. Similar custodial requirements exist for CIDs. Requirements for safeguarding grand jury materials or CIDs are more stringent than for IG subpoenas.

a. Auditor responsibility for safeguarding contractor records is discussed in CAM 1-506. The auditor is not relieved

of responsibility simply because the records in question have been obtained under subpoena or because the contractor itself should be excluded from access to the subpoenaed records. When auditors are detailed to assist an investigation, they should be aware of their responsibility to exercise due care and be mindful that removal of original documents from the designated workplace could result in both significant embarrassment to the Agency and penalties to the auditor.

b. If an auditor is to work under the supervision of an investigator or trial attorney, the acknowledgment of the request for audit services should state that, while the auditor will exercise due professional care, neither the auditor nor the Agency can assume responsibility for the completeness of subpoenaed documents that are not inventoried upon receipt and maintained under appropriate security thereafter.

c. If unsatisfactory conditions are encountered, the cognizant manager or supervisor should advise the head of the investigative agency of the situation in writing. The matter should then be left to the discretion of the investigative office. It is highly unlikely that security problems will arise under a grand jury subpoena; however, in that case, notice of unsatisfactory conditions should be furnished to the trial attorney with a copy to the investigator.

4-702.8 Audit Reports Involving Alleged Subcontractor Fraud

a. Most fraud statutes provide for measurement of total cost impact to the government for damages resulting from subcontractor fraud or false statements. For example, a second-tier subcontractor may make a false statement to a first-tier subcontractor resulting in a \$1 million defective pricing. If the first-tier subcontractor and the prime contractor rely on the defective data, the impact to the government would exceed \$1 million after adding the two additional levels of overhead, G&A, and profit. In this example, the second-tier subcontractor would be liable for the entire cost impact to the government (plus penalties) even though its gain was only \$1 million. This situa-

tion differs significantly from a non-fraudulent defective pricing case where the government would seek recovery of the entire cost impact from the prime contractor. In non-fraudulent subcontractor defective pricing cases, the audit report procedures described in 10-602b. apply (i.e., subcontract audit reports are provided to the prime contract auditor who issues a consolidated report to the procurement authority).

b. In subcontract fraud matters, auditors at subcontractor locations are usually requested by investigators or attorneys to determine the total cost impact to the government. In such cases, the subcontractor FAO should assume full responsibility for coordinating all audit activity necessary to respond to the request. Accordingly, the subcontractor FAO should request audit assistance from FAOs with audit cognizance over any higher-tier contractors and incorporate the results into a single consolidated report to the requestor. Use this procedure regardless of the number of higher-tier contractors. As part of this process, the subcontractor FAO should identify information needed from the higher-tier locations and supply the higher-tier auditors with any data necessary to assist them in their work. In acknowledging the request from the investigators or attorneys, the subcontractor FAO should inform the requester of arrangements being made for the submission of reports on any (1) technical analysis or (2) reviews of intracompany or higher-tier contractor additive factors.

c. Resolve any disputes between FAOs on administrative procedures or technical accounting matters that arise during assist audits in accordance with 6-806.

4-703 Suspected Contractor Provision of Improper Gifts/Gratuities to Government Personnel

a. The Standards of Ethical Conduct for the Executive branch (5 C.F.R. Part 2635, Subpart B) state that federal employees shall not accept gifts/gratuities directly or indirectly which are given because of the employee's official position or which are given to the employee by a prohibited source. "Direct or indi-

rect acceptance" includes gifts to an employee's parent, sibling, spouse, child or dependent relative given because of the employee's relationship to that other person. "Prohibited sources" are any person or legal entity that: 1) seeks official action from the employee's agency; 2) does business or seeks to do business with the employee's agency; 3) conducts activities regulated by the employee's agency; 4) has interests that may be affected by the performance or nonperformance of the employee's duties; or 5) is an organization, a majority of whose members fall within any one or more of the prior four categories.

b. The Standards of Ethical Conduct for the Executive branch are found at Chapter 2 of DoD's Joint Ethics regulation (JER), DoD 5500.7R. Additionally, 18 U.S.C. 203 makes it a crime for a government employee to receive compensation for his or her duties as a government employee from anyone other than the government. It also makes it a crime for someone to pay such compensation to a government employee.

c. A violation of 18 U.S.C. 203 or DoDD 5500.7 may become the subject of an investigation and can result in disciplinary action. DCAA auditors do not have a designated mission to monitor compliance with either the Standards of Ethical Conduct or the statute; consequently, audit programs do not contain specific steps to detect noncompliance. However, any apparent noncompliance coming to your attention, regardless of the length of time since the suspected event occurred, is referable. Be aware, however, that there are exclusions from the definition of a gift and a number of listed exceptions to the gift prohibition including a blanket exception for gifts valued at less than \$20 per occasion and \$50 per calendar year. The exclusions and exceptions are found on pages 2-7 through 20-14 of Chapter 2 of the JER. Therefore, be sure to review these exceptions before making a referral. Forward suspected offers or acceptances of gratuities even though no recipient can be identified or no investigative lead is apparent. The requirements for referral of personnel from other Federal agencies who have accepted gifts, gratuities, loans,

favors, or entertainment are the same as those for DoD employees (see 4-704).

(1) The referral (DCAAF 2000.0 may be used) must contain as much information as is available. Such information includes the identity of the offeror and recipient (names, position titles, and agency/department or contractor), type of gratuity, range in dollar value of the gratuity or benefit detected, estimated total dollar value, the records reviewed, whether access to any records was denied, and why the auditor suspects that a gratuity was offered or received. Also, state whether the contractor is aware of the condition and, if so, include comments on the nature of corrective action taken or contemplated, including the adequacy of any repayments to the government.

(2) Do not forward with the referral many copies of essentially duplicative documents from the contractor's records, such as expense vouchers. Instead, forward one or two representative samples of such records along with a listing of pertinent information such as names, dates, and amounts extracted from the records. All copies should be legible. If it is not possible to obtain a legible copy, state this fact in the referral and briefly describe the document.

(3) Send the referral to Headquarters, Attn: OPD, with copies to the regional director. OPD will review the referral for possible forwarding to the appropriate investigative agency.

4-704 Suspected Violations of the Anti-Kickback Act (41 U.S.C. 51 to 58)

4-704.1 General

a. The Anti-Kickback Act (4-7S1) prohibits providing, attempting to provide, or offering to provide any kickback; soliciting, accepting, or attempting to accept any kickback; or including, directly or indirectly, any kickback in the contract price charged by a subcontractor to a prime contractor or a higher-tier subcontractor or in the contract price charged by a prime contractor to the government.

b. Kickback is defined as any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

4-704.2 Examples of Questionable Practices

Questionable practices under the Anti-Kickback Act may take such form as: payments of commissions to prime contractor personnel; entertainment provided for prime contractor personnel; loans to prime or higher-tier contractor personnel that may not be repaid and may be later recorded as an expense on the subcontractor's records; and expensive gifts or preferential treatment to particular subcontractors.

4-704.3 Audit Responsibilities

Ascertain that contractors have informed (1) their personnel who award or administer subcontracts or purchase orders and (2) their subcontractors and suppliers about the provisions of the amended Anti-Kickback Act and questionable practices thereunder. If such action has not been taken by a contractor, recommend that the contracting officer require such action. In addition, cooperate to the extent necessary to ensure that the contractor's procurement personnel are aware of the provisions of the Act.

4-704.4 Referral Requirements

Because Public Law 99-634, "Anti-Kickback Enforcement Act of 1986," imposes a duty on the contractor to promptly report the possible violation in writing to the Inspector General of the contracting agency, to the head of the contracting agency if the agency does not have an Inspector General, or to the Department of Justice, the contractor has a statutorily imposed duty to self-report. Therefore, suspected kickbacks are ineligible for inclusion in the Voluntary Disclosure Program. When there is reason to believe that a violation of the Act has

occurred, and the cognizant Defense criminal investigative organization has not been notified, the auditor shall promptly prepare a DCAA Form 2000.0. The Form 2000.0 will state all known details of the transaction. Coordinate and forward the Form 2000.0 in the same manner as those on suspected fraud (see 4-702.4).

4-705 Suspected Anticompetitive Procurement Practices

a. Anticompetitive procurement practices are those designed to eliminate competition or restrain trade. They include but are not limited to collusive bidding, follow-the-leader pricing, rotated low bids, sharing the business, or identical bids. They do not include bona fide sole-source procurement actions, violations of the Competition in Contracting Act by the procuring activity, or buying-in by a contractor.

b. If information received from any source indicates suspected anticompetitive procurement practices by a contractor or subcontractor, determine, by appropriate audit techniques, whether sufficient evidence exists to indicate an improper practice. If it does, promptly submit a referral using the procedures set forth in 4-702.4.

4-706 Suspected Illegal Political Contributions

4-706.1 The Statute

a. Title 2 U.S.C. 441C, in essence, prohibits any firm or person contracting with the United States from making a contribution to or expenditure for a political party, committee, candidate for public office, or any person, for a political purpose or use.

b. The term "contribution" includes: (1) any gift, subscription, loan, advance, or deposit of money or anything of value made by any person for the purpose of influencing any election for Federal office; or (2) the payment by any person of compensation for the personal services of another person which are given to a political committee without charge for any purpose.

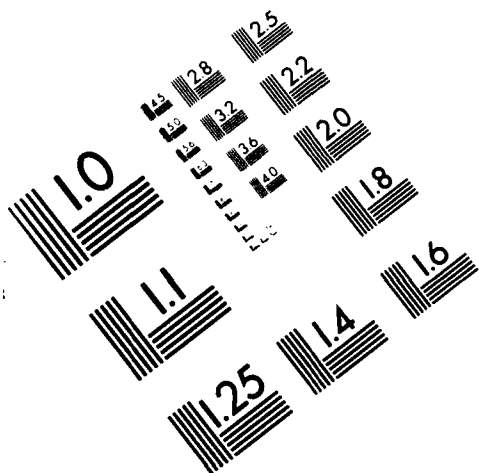
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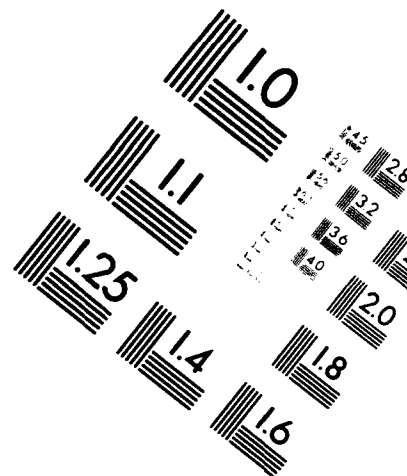
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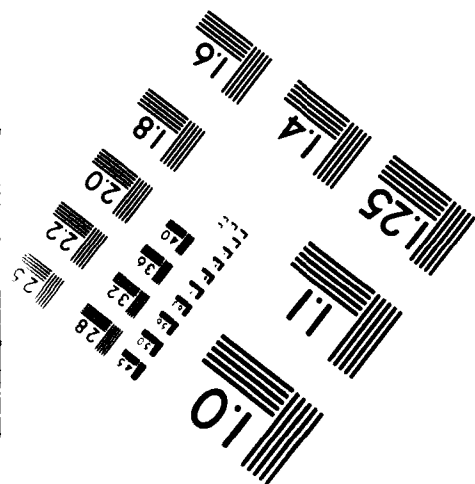
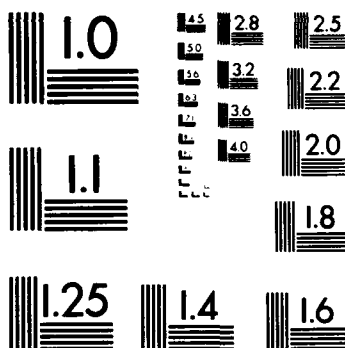
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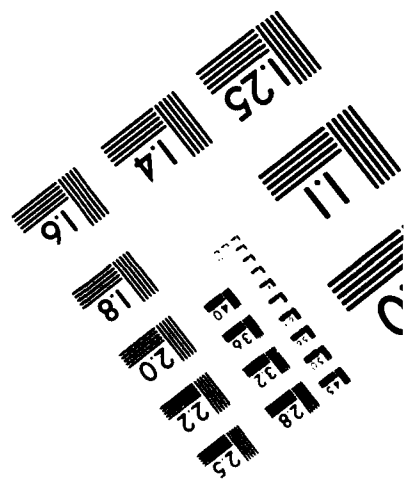
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4-706.2 Methods of Channeling Inappropriate Expenditures

Corporations that make illegal political contributions may use several means to channel such payments to the intended recipient. Be alert to such methods as:

a. Bonus payments to contractor personnel passed on by the employee as a personal contribution or returned to the company to make the contribution. These payments usually cover taxes paid by the employee. Review carefully any bonus payments which might be based on a formula designed to cover taxes due.

b. Payments to outside consultants or other professional contacts. Such payments may be too high for the service received or there may be no services received at all. Scrutinize high or unusual professional and consultant service expenses for inappropriate expenditures. Such scrutiny involves a comprehensive review of supporting documentation, which should state the extent of services provided.

c. Padding or falsifying expenses paid to employees. Such expenses may include travel, dues, memberships and subscriptions, training, educational expenses, or any expenses where the contractor makes payment based on an invoice from an employee or a close, outside associate.

4-706.3 Audit Responsibilities

It would be impractical to perform the audit effort necessary to disclose every illegal political contribution. However, government auditing standards require auditors to design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, illegal acts, or other unlawful activity that could significantly affect the audit objectives or results of audit (see 4-702.2a).

4-706.4 Referral Requirements

When a violation of the statute is suspected, submit a report describing all known details of the transaction to Headquarters, Attn: OPD, for possible referral to the Federal Election Commission. The DCAAF 2000.0 may be used for this purpose. "Early alerts" are not required when reporting this suspected misconduct.

4-707 Voluntary Disclosure Program

4-707.1 General

a. The Department of Defense encourages contractors to adopt, as a central part of corporate self-governance, a policy of voluntarily disclosing problems affecting their contractual relationship with the DoD. The program is intended to be mutually advantageous to both the government and contractors. Such advantages include: (1) increased likelihood of the government recouping losses of which it might otherwise be unaware; (2) reduction in the work required by the government to investigate the problem; (3) relaxation of adversarial tensions between the government and contractors, thus expediting consideration of remedies by the DoD and the Department of Justice (DOJ); (4) positive indications of contractor integrity by their disclosure and cooperation; and (5) increased likelihood of self-initiated corrective actions by contractors.

b. In return for voluntarily disclosing potential fraud and agreeing to cooperate in any government audit and investigation, the government will generally allow a contractor to conduct an internal investigation which the government will attempt to verify in an expedited manner. DoD will also generally agree not to initiate suspension or debarment action until this verification process is completed. Determinations regarding suspension and debarment will consider the contractor's achievements in ensuring corporate integrity. Prompt voluntary disclosure, full cooperation, complete access to contractor records, restitution, and adequate corrective actions are considered key indicators of contractor integrity.

c. To be accepted into the DoD Voluntary Disclosure Program, (1) the disclosure must not be triggered by the contractor's recognition that the underlying facts are about to be discovered by the government through audit, investigation, or contract administration efforts, or reported to the government by third parties; (2) the disclosure must be on behalf of the business entity, in contrast to admissions by individual officials or employees; (3)

prompt and complete corrective action, including disciplinary action and restitution to the government when appropriate, must be taken by the contractor in response to the matters disclosed; and (4) after disclosure, the contractor must cooperate fully with the government in any ensuing investigation or audit. If suspected irregularities are found during a joint audit as described in 4-702.1d, the contractor will have 30 days to make a voluntary disclosure (see 4-702.2d).

d. The Assistant Inspector General for Investigations, Office of Criminal Policy and Oversight, (AIG(CIPO)) serves as the focal point for the dissemination of general information concerning the Voluntary Disclosure Program, administers the program, and coordinates administrative action within DoD. Inform defense contractors wishing to make a disclosure of potential fraud as part of the Voluntary Disclosure Program to contact the Voluntary Disclosure Program Manager at telephone number (703) 614-8960. Matters not involving potential criminal or civil fraud, i.e., those that are contractual or administrative in nature, may be reported to the cognizant contracting officer or DCAA office.

e. One defense criminal investigative organization (DCIO) will serve as the lead investigative agency to verify the accuracy and completeness of the matter(s) disclosed. In most instances, the lead DCIO will request DCAA to conduct an audit. The DCAA auditor assigned will be briefed on the DCIO investigative plan to ensure a coordinated effort. If enough information is available and the circumstances warrant, the DCIO may begin its investigation before completion or in conjunction with the audit.

4-707.2 Audit Responsibility

a. Regardless of the type of audit activity involved, treat requests for DCAA assistance related to voluntary disclosures as demand assignments and schedule them for completion on that basis. (See 4-702.6 for the procedures to follow when responding to such requests.) Prompt completion is usually critical to a criminal or civil investigation. Accordingly, inform requesters im-

mediately of any anticipated delays in the performance of the audit.

b. The scope of the audit will focus on the matters disclosed by the contractor and include a quantification of the government loss. Unrelated fraud allegations developed during the verification process are to be pursued by the initiation of an independent audit or investigation using normal procedures (see 4-702.4) unless the relationship to the matter disclosed is so commingled as to prevent their severance. Do not treat such additional allegations as part of the Voluntary Disclosure Program without prior coordination with the lead DCIO.

c. Contractor cooperation is essential to the audit. When contractor cooperation is unsatisfactory, promptly notify the lead DCIO. It is the responsibility of the DCIO to ensure access to information required for the verification audit.

d. Situations may occur in which a contractor or its legal counsel attempts to make a voluntary disclosure of potential civil or criminal fraud directly to DCAA. If this happens, the FAO should:

(1) Determine if the disclosure has any immediate impact on costs charged to government contracts that would warrant suspension or disallowance of costs. If yes, bring the matter to the attention of Headquarters (OPD), through the regional office, before suspensions or disallowances are made.

(2) Inform the ACO of the disclosure, if he or she is not already aware.

(3) Determine if the contractor has made or intends to make a disclosure under the Voluntary Disclosure Program. If yes, direct them to contact the Voluntary Disclosure Program Manager if they have not done so already (see 4-707.1d.) and allow the contractor to proceed with its own investigation without initiating a parallel audit. Confirm, however, that the contractor has made the formal disclosure.

(4) If the contractor does not make a formal disclosure, evaluate the situation using the guidance in 4-702. The FAO or region should consult with Headquarters (OPD) before submitting a DCAAF 2000.0.

4-707.2d.

(5) Immediately forward any documentation concerning an attempted voluntary disclosure to Headquarters (OPD).

e. Under no circumstances (fraud or no fraud) are DCAA personnel to accept refund checks.

f. On occasion a contracting officer who has received a voluntary disclosure may request DCAA assistance. In such cases, follow the procedures in paragraphs a - e above. If you are aware of a voluntary disclosure made to a contracting officer, provide Headquarters (OPD) a narrative report on the incident, accompanied by all pertinent documentation. Do not follow the procedures in 4-702.4.

4-707.3 Audit Reports

a. Audit reports will be addressed to the DCIO requesting the audit. In addition, a copy will normally be furnished to the ACO, affected PCOs, and the DCAA Justice Liaison Auditor (see 4-702.5b.). If the requester asks that distribution of the report be limited, refer the matter to Headquarters (OPD) through the cognizant Regional Audit Manager.

b. Audit of a voluntary disclosure is to be performed in accordance with the guidance covering the matter(s) disclosed, and the auditor should identify and review similar transactions to confirm that the disclosure was complete. For example, a disclosure of defective pricing should be reviewed in accordance with 14-100, and the defective pricing potential of contracts awarded under circumstances similar to those affected by the disclosed irregularity should be reviewed. If the irregularity affects a subcontract, include the impact of prime contractor additives as discussed in 4-702.8. Since the contractor is required to provide data supporting its findings and computations, procedures applicable to audits of voluntary disclosures are not considered to be investigative in nature, and the restrictions in 4-702.5 and 4-702.6 do not apply. To the extent possible, tests of transactions and other routine audit procedures performed during reviews of voluntary disclosures should be incorporated in the ongoing workload to satisfy requirements of the affected audit area.

c. Prepare audit reports using the format in 10-1200. However, be certain all relevant issues are covered. Do not hesitate to expand the report format in the interest of clarity.

d. Do not release results of audit, including draft condition statements or recommendations, to the contractor before consulting with and obtaining the approval of the DCIO. Discuss factual matters with the contractor only to the extent necessary to ensure accuracy. These procedures are necessary to prevent premature release of audit results which could compromise government actions regarding the condition under investigation.

4-708 Obstruction of Audit Provision of the Anti-Drug Abuse Act of 1988

a. The Anti-Drug Abuse Act of 1988 (P.L. 100-690) added section 1516 to Title 18, U.S.C., which contains an obstruction of audit provision. This provision makes it a crime for a person or corporation to endeavor to influence, obstruct, or impede, with the intent to deceive or defraud the government, a Federal auditor in the performance of official duties. The purpose of the provision is to punish acts designed to prevent an auditor from discovering or reporting fraud or deceit against the government. The provision does not make it a crime to deny an auditor access to records unless the purpose of the denial is to prevent such discovery. Therefore, do not report a suspicion of fraud or other unlawful activity solely on the basis that access to records was denied. Pursue access to records problems in accordance with 1-504.4.

b. If there is a reasonable basis to suspect fraud or deceit against the government, and you believe a denial of access to records is an attempt to prevent an auditor from discovering or reporting this fraud or deceit, include this information in a suspected fraud referral (see 4-702.4). The mere denial of access to records, however, is not by itself a reasonable basis to suspect fraud.

c. When reporting suspicions of fraud or other unlawful activity (see 4-702.4), include any information on suspected

contractor efforts to influence, obstruct, or impede an auditor with the intent to deceive or defraud the government.

4-709 Qui Tam Actions Under the Civil False Claims Act

Qui tam actions are civil, not criminal, actions, which are brought under the authority of the Civil False Claims Act. In such a suit, the plaintiff brings the action on behalf of the government. A qui tam suit is filed under seal. The defendant contractor is not provided with a copy of the filing nor is it to be told the contents of the filing while the action is under seal. The government is furnished a copy of the filing and has 60 days in which to make a decision on whether it will join in the suit. To assist its deliberations, the Department of Justice will frequently seek information about the defendant contractor from DCAA. Information in our files and working papers is to be made readily available to the attorney handling the case as well as any DoD personnel supporting the attorney. Any requests for additional audit support will be treated as a demand assignment. The contractor is not to be informed of the source of these requests without the approval of the requesting attorney. At the same time, the FAO should determine if the attorney has any objections to providing the results of the audit to the contracting officer. If there are none, a report should be sent to the contracting officer. However, the report will caution that the audit was conducted in connection with a qui tam suit and that before any contractual action is taken on the matter, permission must be obtained from the responsible attorney.

4-710 Defense Hotline

a. The Defense Hotline is an element of the Office of the Assistant Inspector General for Departmental Inquiries which serves as a clearinghouse for audit and investigative leads. It receives allegations from Government entities such as DoD, from private individuals both inside and outside the Government, and from the GAO. The Hotline assigns review of these leads to the audit or investi-

gative agency it believes is best qualified to determine their validity; monitors the progress of the examination; and tabulates and reports case dispositions. Hotline personnel neither perform investigative tasks nor initiate corrective actions. DCAA responsibilities for reviewing Hotline referrals are set out in DCAAR 7600.1.

b. The Hotline is obligated to protect the anonymity of informants who either request confidentiality or do not disclose their identity. Hotline materials arising from such a source are clearly marked. In order to evaluate a Hotline referral, it may be necessary to advise a contractor that an audit lead has been received. The Hotline should not be identified as the source of the lead. Under no circumstances may Hotline materials arising from a confidential or anonymous source be released outside the Government. The Headquarter's, DCAA transmittal of a sensitive Hotline referral will make specific reference to nondisclosure requirements in its opening paragraph.

c. At its discretion, the Hotline may determine that an allegation either lacks sufficient detail for follow-up or presents no likelihood of harm to the Government. Such a matter will be classified as an optional referral. All other referrals are mandatory, and are assigned a due date. Hotline referrals are reviewed in Headquarters, OPD, and are forwarded to the cognizant regional office for information or response. The regional office may further delegate responsibility. Delegation of the decision to conduct a field review of an otherwise optional referral does not convert the status of a referral from an optional to a mandatory response. However, if a field review is undertaken, results must be reported to the Hotline.

d. All Hotline referrals which have been assigned due dates, either by the Hotline or by Headquarters, are to be treated as demand assignments. If a due date cannot be met, an extension should be requested by filing a Hotline Progress Report (DCAAR 7600.1). The Hotline has suggested that six month extension requests reduce unnecessary proliferation of progress reports. It is the responsibility of the Regional Office to assure that

Hotline progress and completion reports are issued in the specified format.

e. When a field review of a Hotline referral is undertaken, allegations are to be treated as audit leads and followed up through audit in accordance with 4-702.2. If questions remain after available audit means commensurate with the Government's risk have been exhausted, arrangements should be made for transfer of the matter to an investigative agency. The responsible field element should discuss the case with the investigative office to which it would have sent a DCAAF 2000.0 had the allegation arisen through audit. (However, matters first reported through the Defense Hotline are deemed to be known to the Government, and therefore ineligible for reporting on the DCAAF 2000.0.) Case responsibility may be transferred by submitting a Hotline Completion Report (DCAAR 7600.1) to Headquarters, Attention OPD, setting out the results of review, the reason(s) for transfer, and the investigative office to which the matter should be transferred.

f. When a referral makes allegations of a technical nature, the assistance of a technical evaluator should be obtained. Occasionally it becomes apparent that the technical evaluator's agency should assume responsibility for the referral, with audit support as needed. When this happens, transfer of responsibility should be formalized similarly to investigative transfer.

g. DCAA's responsibilities are not affected by the source of an audit lead. When review of a Hotline referral leads to positive findings of questioned cost, control weakness, or similar audit matters, the cognizant field audit office should report the matter to procurement and initiate corrective action through the audit reporting process. If available, audit reports containing findings and recommendations which arose from a Hotline referral should be submitted as an enclosure to the Hotline Completion Report.

4-711 Reviewing Contractor Compliance with Administrative Suspension and Debarment Agreements

a. Background. Contractors found to have committed fraud or other miscon-

duct sometimes enter into suspension and debarment agreements to avoid being suspended or debarred from obtaining government contract awards or to be removed from the listing of suspended or debarred companies. These agreements usually require the contractor to implement ethics and fraud prevention programs and strengthen internal controls over the areas where the fraud or other misconduct occurred. Often, the agreements require the contractor to maintain a hotline for employees to report fraud or other irregularities. Sometimes the costs incurred by the contractor to comply with these agreements are unallowable under FAR 31.205-47. Each Service and the Defense Logistics Agency has suspension and debarring officials or designees who are responsible for monitoring contractor compliance with the agreements.

b. Responsibilities. The suspension and debarring officials or designees will request DCAA audit support to review contractor compliance with any provisions of the agreement that relate to DCAA's audit mission. For example, the auditor will generally be requested to review if the contractor is identifying and segregating the unallowable costs being incurred to comply with the agreement. If the agreement also provides for the contractor to make improvements to its internal control systems, the auditor will generally be requested to review if the improvements have been made. The suspension and debarring officials or designees are responsible for assessing overall contractor compliance with the agreement.

c. Briefing of the Agreement and Coordination. At those contractors with suspension and debarment agreements, the FAO should obtain a copy and brief the agreement to identify provisions that fall within DCAA's areas of responsibility. The FAO should then discuss with the responsible suspension and debarring official or designee and the contracting officer the audit services needed to assist in reviewing contractor compliance. Any differences of opinion between the FAO and the suspension and debarring official or designee or any difficulty in arranging a meeting should be communicated

through the Regional Office to PFD for resolution. The results of this coordination should be documented in the FAO's audit planning files.

d. Audit Planning. The FAO normally will not have to establish special audits to provide the needed audit support. The audit steps needed to assist the suspension or debarring official or designee in determining compliance with the provisions of the agreement can be usually performed as part of the FAO's regularly scheduled reviews; e.g., the FAO's planned reviews of internal controls relating to the identification and segregation of unallowable costs. However, if the compliance officer requests a special audit because of his scheduled responsibilities, the FAO should provide the requested services.

e. Corporate Offices. Settlements at the corporate level affecting two or more segments should be coordinated by the corporate auditor or CAC. After the

briefing, the corporate auditor or CAC will disseminate the agreement to the segment auditors with an assist audit request (if applicable) on any services needed to assess compliance with the relevant parts of the agreement.

f. Reporting. The FAO should communicate in writing all noncompliances or other concerns with the agreement to the ACO cognizant of the contractor with a copy to the suspension and debarring official or designee. All applicable DCAA audit reports should contain comments on any contractor actions required by a suspension/debarment agreement until the contractor fully implements or complies with the agreement.

g. Semiannual Updates. On a semiannual basis, PFD will obtain listings of the contractors currently under suspension and debarment agreements and provide them to the regional offices for distribution to the appropriate FAOs.

4-7S1 Supplement - Public Law 99-634, "Anti-Kickback Enforcement Act of 1986"

An Act to prohibit kickbacks relating to subcontracts under Federal government contracts.

Section 1. This Act may be cited as the "Anti-Kickback Act of 1986."

Section 2. As used in this Act:

(1) The term "contracting agency," when used with respect to a prime contractor, means any department, agency, or establishment of the United States which enters into a prime contract with a prime contractor.

(2) The term "kickback" means any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

(3) The term "person" means a corporation, partnership, business association of any kind, trust, joint-stock company, or individual.

(4) The term "prime contract" means a contract or contractual action entered into by the United States for the purpose of obtaining supplies, materials, equipment, or services of any kind.

(5) The term "prime contractor" means a person who has entered into a prime contract with the United States.

(6) The term "prime contractor employee" means any officer, partner, employee, or agent of a prime contractor.

(7) The term "subcontract" means a contract or contractual action entered into by a prime contractor or subcontractor for the purpose of obtaining supplies, materials, equipment, or services of any kind under a prime contract.

(8) The term "subcontractor"

(A) means any person, other than the prime contractor, who offers to furnish or furnishes any supplies, materials, equipment, or services of any kind under a prime contract or a subcontract entered into in connection with such prime contract; and

(B) includes any person who offers to furnish or furnishes general supplies to the prime contractor or a higher tier subcontractor.

(9) The term "subcontractor employee" means any officer, partner, employee, or agent of a subcontractor.

Section 3. It is prohibited for any person —

(1) to provide, attempt to provide, or offer to provide any kickback;

(2) to solicit, accept, or attempt to accept any kickback; or

(3) to include, directly or indirectly, the amount of any kickback prohibited by clause (1) or (2) in the contract price charged by a subcontractor to a prime contractor or a higher tier subcontractor or in the contract price charged by a prime contractor to the United States.

Section 4. Any person who knowingly and willfully engages in conduct prohibited by section 3 shall be imprisoned for not more than 10 years or shall be subject to a fine in accordance with title 18, United States Code, or both.

Section 5. (a)(1) The United States may, in a civil action, recover a civil penalty from any person who knowingly engages in conduct prohibited by section 3. The amount of such civil penalty shall be —

(A) twice the amount of each kickback involved in the violation; and

(B) not more than \$10,000 for each occurrence of prohibited conduct.

(2) The United States may, in a civil action, recover a civil penalty from any person whose employee, subcontractor or subcontractor employee violates section 3 by providing, accepting or charging a kickback. The amount of such civil penalty shall be the amount of that kickback.

(b) A civil action under this section shall be barred unless the action is commenced within 6 years after the later of (1) the date on which the prohibited conduct establishing the cause of action occurred, and (2) the date on which the United States first knew or should reasonably have known that the prohibited conduct had occurred.

Section 6. (a) A contracting officer of a contracting agency may offset the amount of a kickback provided, accepted, or charged in violation of section 3 against any moneys owed by the United States to the prime contractor under the prime contract to which such kickback relates.

(b)(1) Upon direction of a contracting officer of a contracting agency with respect to a prime contract, the prime contractor shall withhold from any sums owed to a subcontractor under a subcontract of the prime contract the amount of any kickback which was or may be offset against that prime contractor under subsection (a).

(2) Such contracting officer may order that sums withheld under paragraph (1) -

(A) be paid over to the contracting agency; or

(B) if the United States has already offset the amount of such sums against that prime contractor, be retained by the prime contractor.

(3) The prime contractor shall notify the contracting officer when an amount is withheld and retained under paragraph (2)(B).

(c) An offset under subsection (a) or a direction or order of a contracting officer under subsection (b) is a claim by the government for the purposes of the Contract Disputes Act of 1978.

(d) As used in this section, the term "contracting officer" has the meaning given that term for the purposes of the Contract Disputes Act of 1978.

Section 7. (a) Each contracting agency shall include in each prime contract awarded by such agency a requirement that the prime contractor shall have in place and follow reasonable procedures designed to prevent and detect violations

of section 3 in its own operations and direct business relationships.

(b) Each contracting agency shall include in each prime contract awarded by such agency a requirement that the prime contractor shall cooperate fully with any Federal government agency investigating a violation of section 3.

(c)(1)(A) Whenever a prime contractor or subcontractor has reasonable grounds to believe that a violation of section 3 may have occurred, the prime contractor or subcontractor shall promptly report the possible violation in writing.

(B) A contractor shall make the reports required by subparagraph (A) to the inspector general of the contracting agency, the head of the contracting agency if the agency does not have an inspector general, or the Department of Justice.

(2) In the case of an administrative or contractual action to suspend or debar any person who is eligible to enter into contracts with the Federal government, evidence that such person has supplied information to the United States pursuant to paragraph (1) shall be favorable evidence of such person's responsibility for the purposes of Federal procurement laws and regulations.

Section 8. For the purpose of ascertaining whether there has been a violation of section 3 with respect to any prime contract, the General Accounting Office and the inspector general of the contracting agency, or a representative of such contracting agency designated by the head of such agency if the agency does not have an inspector general, shall have access to and may inspect the facilities and audit the books and records, including any electronic data or records, of any prime contractor or subcontractor under a prime contract awarded by such agency.

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FIGURE 4-7-1

PRO FORMA CAUTIONARY TRANSMITTAL MEMORANDUM

FOR OFFICIAL USE ONLY

MEMORANDUM FOR (name and address of requester)

SUBJECT: Cautionary Statement Related to Audit Report (audit report number, date and subject, and the contractor's name and location)

The attached audit report addresses certain matters which have raised a suspicion of potential fraud on the part of (indicate the name of the company involved). Specifically, those matters are (describe the suspected fraudulent conduct). We are willing to discuss these matters with you, your counsel, and representatives of the cognizant criminal investigative organization in an effort to reach a proper disposition of these issues in light of the requirements of DoD Directive 7050.5, Coordination of Remedies for Fraud and Corruption Related to Procurement Activities.

(Signature)

Branch Manager

FOR OFFICIAL USE ONLY

Figure 4-7-2

(Use full size form or DIIS Version for reporting)

FOR DCAA HEADQUARTERS USE ONLY DCAA CASE NO.: _____
--

SUSPECTED IRREGULARITY REFERRAL FORM

Name of DCAA Employee
Submitting Referral (Print) _____

Employee Location/Phone: _____

FAO Manager's Approval:

Name (Print) _____

Signature _____

Date _____

FAO Name/RORG Code/Phone: _____

Instructions

Auditor – Information which suggests a reasonable basis for suspicion of fraud, corruption, or unlawful activity affecting Government contracts must be reported promptly. DCAA employees are encouraged to use this form.

This form is designed to identify the type of information typically needed by an investigator. Although you may not be able to supply all of the information, be as thorough as possible in order to assist the investigator in understanding the possible irregularity.

You are required to discuss your suspicions and your written submission with your supervisor to assure that adequate information has been developed.

Supervisor/FAO Manager – Process the form in accordance with DCAA Instruction 7640.16. If there is any question as to whether or not this referral should be made, discuss it with the investigative office or your regional audit manager. The FAO manager should sign and date the form before forwarding it to Headquarters, DCAA (OPD), or making other required distributions. The FAO manager's signature indicates that the information contained in the Form 2000.0 is complete and accurate and that (s)he believes the facts presented raise a reasonable suspicion of fraud, corruption, or other unlawful activity affecting Government contracts.

Classification of Irregularity

To assist in the evaluation of the material presented, please check each type of irregularity you have reason to believe may have occurred. Check all that apply. Circle the primary irregularity. For example, mischarging unallowable advertising costs into a supplies account in a certified overhead proposal would be described by checking 5c, identifying it as a false incurred cost certification, and circling 4a (FAR unallowables).

- | | |
|--|---|
| <p>1. Defective Pricing</p> <p>___ a. Pattern of Activity</p> <p>___ b. Other: _____</p> <p>2. Billing Irregularities</p> <p>___ a. Progress Payments</p> <p>___ b. Public Vouchers</p> <p>___ c. Other: _____</p> <p>3. Labor Irregularities</p> <p>___ a. Timekeeping Irregularities</p> <p>___ b. IR&D/B&P Mischarging</p> <p>___ c. Other Mischarging: _____</p> <p>4. Accounting Mischarging</p> <p>___ a. FAR 31/CAS 405 Violations</p> <p>___ b. Improper Transfers</p> <p>___ c. Unallocable Costs</p> <p>___ d. Other: _____</p> <p>5. False Claims and Certifications</p> <p>___ a. Equitable Adjustment Claims</p> <p>___ b. Termination Settlements</p> <p>___ c. Indirect Cost Certification</p> <p>___ d. Other: _____</p> | <p>6. Consultants & Subcontractors</p> <p>___ a. Consultant Irregularities</p> <p>___ b. Subcontracting Irregularities</p> <p>7. Materials</p> <p>___ a. Product Substitution</p> <p>___ b. MMAS</p> <p>___ c. Other: _____</p> <p>8. Ethical Violations</p> <p>___ a. Kickbacks</p> <p>___ b. Gratuities</p> <p>___ c. Political Contributions</p> <p>___ d. Foreign Corrupt Practices Act</p> <p>___ e. Bribery</p> <p>___ f. Restraints of Trade</p> <p>___ g. Other: _____</p> <p>9. Other Irregular Activity</p> <p>___ a. Conspiracy</p> <p>___ b. Obstruction of an Audit (but see CAM 4-708)</p> <p>___ c. Other: _____</p> |
|--|---|

Figure 4-7-2

NOTE: Certain types of irregularity should not be reported on the Form 2000.0. These include: matters already known to the Government such as suspected irregularities referred to DCAA for audit evaluation by another Government agency (e.g., Hotline referrals); contractor voluntary disclosures (CAM 4-707); qui tam complaints (CAM 4-709); unsatisfactory conditions (CAM 4-800), especially 4-803, "Serious Weaknesses on the Part of Contractor or Government Personnel;" and violations of DoD Standards of Conduct by DCAA employees (DCAAR 5500.2). Additionally, nothing contained on this form should be interpreted as requiring the referral of routine audit findings or disagreements with contractors or contracting officers for investigation.

PART I - Contractor, Contracts, and Program Involved

- a) - Name of contractor. _____
 Division. _____
 City, State, Zip. _____
 Location of Incident. _____

- b) - Contracts Affected. If specific contracts can be identified, please provide the information below on the largest of these:

Contract Number	Contract Type	Amount
_____	_____	_____
_____	_____	_____

If only general categories of contracts can be identified, provide whatever information is available on their type and value below:

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Figure 4-7-2

- c) - Is there a pending contract modification, adjustment, claim resolution or agreement that relates in any way to the suspected irregularity? Explain.

- d) - Name of affected major acquisition program, if any.

- e) - Organization and location which administers the (sub)contract(s).

- f) - Organization and location which awarded the (sub)contract(s).

PART II - Suspected Irregularity

Answer the following questions as fully as possible. Additional sheets of paper may be used to answer any of the questions if necessary.

- a) - Description of Irregularity - Provide a thorough description of the suspected irregularity or irregularities identified in the checklist on page 2, including reference, when known, to any regulatory provision(s) you believe may have been violated. Attach copies of any documents you believe are necessary to assist in understanding the irregular activity and why it is suspected. If documents are attached, be sure that they are referenced in your description.

- b) - What information suggests that the suspected irregularity was not accidental or inadvertent?

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- c) - Identify the means by which the irregularity was accomplished (e.g., altered or falsified time cards, bogus invoices, deceit by suppression of the truth, theft).

- d) - How was the irregularity identified (tip; overhead conversation; inference from audit evidence (describe), etc.)

- e) - Provide a full description of the books and records which are pertinent to the irregularity along with the contractor's nomenclature for these books and records.

- f) - Name, position, and location of individuals who provided information or who may have relevant information.

- g) - Estimate the loss or impact to known Government contracts with this contractor. If loss or impact can only be measured on one contract, then estimate that amount.

- h) - Describe the extent of the questionable practices, including the time span involved and whether it is an isolated incident or a pattern.

- i) - Position and name of person(s) involved.

- j) - Indicators of involvement of upper management.

- k) - If Irregularity Category 9b (Obstruction of an Audit) was checked, briefly describe the difficulties experienced.

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PART III - Related Audit Activity

- a) - Type of audit being performed when suspected irregularity was detected. (Also provide the audit assignment number.)

- b) - Is continued audit effort planned for this audit assignment and/or does the FAO plan to extend, expand, or redirect audit effort in ensuing audits of the referred contractor?

List the audit assignment number(s) for new audit effort.

- c) - Are there any other in-process audits or completed audits related in any way to the suspected irregularity? List the audit assignment number(s).

PART IV - Distribution of Form 2000.0

Please check all organizations to which distribution of this referral is being made.

- ☒ DCAA Headquarters (ATTN: OPD)
☒ Defense Procurement Fraud Unit (DPFU) (ATTN: JLA)
☐ Defense Criminal Investigation Service (DCIS)
☐ Army Criminal Investigative Command (CID)
☐ Naval Investigative Service (NIS)
☐ Air Force Office of Special Investigations (AFOSI)
☐ Administrative Contracting Officer (ACO) [unless advised to the contrary by the investigative organization]
Identify: _____
☐ Procurement Contracting Officer (PCO) [unless advised to the contrary by the investigative organization]
Identify: _____
☐ Other: _____

Figure 4-7-3

Examples of Characteristics and Types of Activity Associated with Illegal Expenditures and Acts for Specific Audit Areas

Audit Area	Indicators
Labor	<p>Unexplained changes to timecards transferring hours from commercial firm-fixed-price contracts to government cost-type contracts.</p> <p>Employee time charged differently than associated travel costs.</p> <p>Diverting labor from firm-fixed-price contract by reclassifying employees as indirect who provide direct labor to firm-fixed-price contracts</p>
Material	<p>Significant material requirements charged to government cost-type contracts where follow-up work shows that the material was not needed.</p> <p>Using inferior material on government contracts that does not meet contract specifications.</p> <p>False certification of inspection test results.</p>
Subcontracts	<p>Intercompany profit claimed and billed for a intercompany affiliate that the contractor represented to the government was an unrelated subcontractor.</p>
Indirect Cost	<p>Overrun contract costs charged to indirect expenses for allocation to other contracts.</p> <p>Expressly unallowable costs recorded in accounts that are generally allowable such as small tools and supplies.</p> <p>Improper transfers, or recording, of costs to indirect accounts for direct contract costs that are not allowed to be charged under the terms of the contract.</p>
Defective Pricing	<p>See 14-121.2 for listing.</p>
All Audit Areas	<p>Alterations to documents that would result in improper costs claimed for government contracts.</p> <p>Evidence showing that payments were not actually made for the amounts shown on the document.</p>

4-800 Section 8 — Special Reporting of Unsatisfactory Conditions**4-801 Introduction**

This section contains guidance and procedures on special reporting requirements on unsatisfactory conditions noted by contract auditors that are not reportable under section 7 of this chapter.

4-802 Voluntary Refunds for "Windfall Profits"**4-802.1 Introduction**

DFARS Subpart 242.71 expresses DoD policy and general procedures on the solicitation or acceptance of voluntary refunds from contractors or subcontractors.

4-802.2 Audit Responsibility

When the contract auditor reaches a conclusion pursuant to 4-802.3 that it may be appropriate to seek a voluntary refund, the auditor should observe DFARS Subpart 242.71 carefully, and inform the cognizant administrative contracting officer, in writing, of this conclusion and its basis, either in an audit report or otherwise.

4-802.3 Audit Procedures

On audits of any type, auditors should be alert to situations where the government was overcharged under a contract; was inadequately compensated for the use of government-owned property, or in the disposition of contractor inventory; and where the contractor's or subcontractor's retention of the amount in question would be contrary to good conscience and equity. If any of these situations are disclosed and it is due, at least in part, to the fault of the contractor or subcontractor, the government may request a voluntary refund or credit, provided the adjustment is not otherwise required by contractual terms or statutory requirements such as 10 U.S.C. 2306a.

4-802.4 Audit Reports

a. Prepare reports on situations involving voluntary refunds in a narrative format pursuant to 10-1200. A decision to seek a voluntary price adjustment must

be made by the Secretary concerned. Therefore, the report or letter should contain sufficient information to permit adequate consideration of the facts and to support a decision at that level.

b. Address a report or letter involving a subcontractor to the contracting officer and forward it through the office which has audit cognizance of the prime contractor. Where audit cognizance has not been established for the prime contract and the prime contractor is not otherwise subject to audit by another audit office, transmit the report directly to the contracting officer in the same manner as if it involved a prime contract.

4-803 Unsatisfactory Conditions (Serious Weaknesses, Mismanagement, Negligence, etc.) on the Part of Contractor or Government Personnel**4-803.1 Introduction**

Unsatisfactory conditions, such as repeated and significant deficiencies in accounting or estimating practices, mismanagement or negligence, and failure to comply with acquisition regulations may result in significant monetary loss or cost to the government, or frustrate public policy.

4-803.2 Examples of Questionable Practices

a. Examples of unsatisfactory conditions in contractor operations include, but are not limited to, the following:

(1) An estimating system and related practices so deficient that price proposals are consistently unreliable, resulting in widespread defective pricing.

(2) Significant and chronic violations of Cost Accounting Standards.

(3) Internal control weaknesses of a magnitude that could cause significant monetary loss to the contractor and excessive cost to the government.

(4) Excessive or premature contractor reimbursement because of inappropriate application or review of economic price adjustment provisions.

14-803.2a.

(5) A contractor's refusal to certify its overhead proposal as required by DFARS 242.770-2.

(6) Failure to pay the minimum wages required by the Davis-Bacon Act, Walsh-Healey Public Contract Act, or the Service Contract Act.

b. While DCAA does not have responsibility for auditing government operations, auditors should report situations where it appears to the auditor that any government official has failed to comply with specific regulatory requirements or is grossly negligent in fulfilling his or her responsibility resulting in substantial harm to the government interest.

4-803.3 Audit Responsibilities

Serious weaknesses causing major audit problems encountered during audit performance should be discussed with the contractor, the principal cognizant ACO, and the CAC as soon as possible so as to expedite the resolution process. The auditor should not wait until the final exit conference or the issuance of the audit report to convey such findings. All such discussions should be documented by appropriate memorandums or notations in the working papers and a sepa-

rate audit report issued using the procedures in 10-400, 10-800, or 10-1200.

4-803.4 Headquarters Reporting Requirements

a. When an FAO encounters unsatisfactory conditions in contractor operations and the issue cannot be resolved at the FAO level, the regional office should become involved promptly and actively.

b. All FAO encounters of unsatisfactory conditions involving government operations require prompt regional office involvement.

c. If the condition is not or cannot be corrected after all FAO and regional office efforts have been exhausted, prepare a Headquarters report (Do not use DCAAF 2000.0) describing the condition along with the actions taken to correct it and submit it through the regional director to Headquarters, Attn: O and DL. Before the report is submitted, the regional director will assure that it contains all pertinent facts and a comprehensive explanation of all actions taken to resolve the matter. Wherever determinable, it should include the monetary amount involved.

4-900 Section 9 — Obtaining Audit Guidance**4-901 Introduction**

This section states policies and procedures for processing requests to regional offices and Headquarters for expert advice, assistance, and guidance on significant auditing and accounting issues. Requirements for feedback to Headquarters on the application of guidance received are included.

4-902 Obtaining Guidance**4-902.1 Definition**

For purposes of this paragraph, auditing and accounting issues mean any questions involving interpretation of the FAR and DFARS cost principles, Cost Accounting Standards (CAS), Generally Accepted Government Auditing Standards (GAGAS), Generally Accepted Accounting Principles (GAAP), or other applicable laws and regulations relating to the conduct of audits or allowability, allocability, or reasonableness of costs charged to government contracts.

4-902.2 Background and General Responsibilities

a. On occasion, field auditors require assistance and advice to help resolve new, unique, complex, or controversial auditing and accounting issues. Before issues are elevated for assistance the FAO, and if necessary the region, will research the issue thoroughly using the FAO and regional libraries. When the FAO's research does not adequately resolve the issue, a request for assistance should be submitted to the regional office.

b. When regions need additional audit guidance, their requests with supporting documentation should be submitted to Headquarters, DCAA, ATTN: P, Bldg 4, Cameron Station, Alexandria, VA 22304-6178 using the following format:

(1) **SUBJECT.** The subject line should always start with the following: "Request for Headquarters guidance on . . ."

(2) **Program Area.** This paragraph should be identified as the major operational area. For example: Forward Pricing, Defective Pricing, Comprehensive Labor, etc.

(3) **Problem/Guidance Identification.** This section should provide a clear and succinct statement of either the problem and/or the guidance area for which the request is being made.

(4) **Regional Staff Review.** This section should provide: (i) the background which generated the request; and, (ii) the nature, extent, and sources used in the regional review prior to submission to Headquarters. As appropriate, the related or background information should be referenced and included as enclosures to the request.

(5) **Regional Alternatives.** This section should provide any alternatives which the regional office may have identified for handling the situation and pro(s)/con(s) of each alternative.

(6) **Regional Recommendation.** This paragraph should identify the regional recommended solution with the supporting rationale.

(7) **Regional Contact.** Identification of the regional focal point, telephone number, and fax number.

c. Headquarters researches Federal laws and regulations, FAR, DFARS, and CAS case history files, decisions of courts and boards of contract appeals, authoritative accounting literature, etc. to develop guidance. When appropriate, legal and/or technical input from outside experts or specialists is obtained.

d. Proposed guidance is coordinated with elements of the Office of the Secretary of Defense (OSD) when appropriate.

e. The feedback required by 4-902.3 below is used to evaluate whether further guidance is needed.

4-902.3 Requirements for Feedback to Headquarters

a. When a guidance memorandum is issued to one region, applicable to a specific issue at a particular FAO, advise the Headquarters division that issued the guidance of the application of the guidance. Regional offices will forward to the appropriate Headquarters division copies of audit reports, memorandums to con-

¶4-902.3a.

tracting officers or others, or letters to contractors or others which reflect application of the Headquarters guidance.

b. Regional offices will also forward to the appropriate Headquarters division copies of any resulting contractor rebuttals, contracting officer comments, relat-

ed legal opinions, or other comments received which: (1) could have an impact on the guidance previously provided, or (2) could lead to the issuance of a general memorandum to all regions and FAOs concerning the issues and related audit guidance.

4-1000 Section 10 — Relying Upon the Work of Others**4-1001 Introduction**

This section provides guidance for relying upon the work of others, except for government technical specialists. For guidance on relying upon the work of government technical specialists, see D-302.

4-1002 General

a. An auditor's work includes the examination or development of sufficient, competent, and relevant evidence to afford a reasonable basis for his/her conclusions and recommendations. In examining or developing evidence, auditors may rely upon the work of others to the extent feasible once they satisfy themselves of the quality of the other's work by appropriate tests or by other acceptable methods. Work performed by another DCAA auditor is to be presumed of sufficient quality based on DCAA's managerial controls.

b. Documentation of work performed and evidence acquired or examined is maintained or referenced in the form of working papers. Working papers are the link between field work and the audit report. They should be complete and accurate; provide support for findings, judgments, and conclusions; and demonstrate the nature and scope of the work performed (see 2-306 and 4-400).

4-1003 Work Performed by Others

An important source of evidence is work performed by other DCAA or government auditors, contract administration office staff, independent public accountants, contractor internal auditors and nonauditors. It is important to maintain effective communications with these groups, to understand their responsibilities, and to know when it is appropriate to request their assistance or rely upon their work. Coordinating with these groups can often provide additional audit evidence and avoid the duplication of effort. Following is a partial list of other sources of reliance:

a. Labor reviews, floor checks, operations/EDP/ financial control audits, systems surveys, etc., performed by regional or other special DCAA audit teams.

b. Assist audits performed by other DCAA audit offices on subcontracts, off-site labor, etc., or on costs which are allocated from, or records which are maintained at, home offices, other divisions, segments, cost centers, etc.

c. Reviews performed by contract administration office staff on special cost-related subjects, procurement and inventory systems, etc.

d. Contractor internal audits and other self-governance functions (see 4-202 and 4-302.1b.(5)).

e. Reviews performed by the General Accounting Office or the Inspector General.

f. Reviews performed by independent public accountants (e.g., internal control reviews conducted in conjunction with financial statement audits; see 4-302.1b.(5)).

4-1004 Deciding Whether to Rely on the Work of Others**4-1004.1 General Evaluation Criteria**

a. Relying on the work of others reduces the amount of work necessary to accomplish audit objectives. The evaluation of the others' work is dependent on the exercise of sound professional judgment. The work of others has to be adequate to provide reasonable assurance that the DCAA audit objectives were accomplished. Care should be taken not to dismiss the work of others for some noncritical deficiency. In deciding whether to rely on the work of others, the DCAA auditor must first evaluate the competence, independence, and objectivity of the external and internal auditors, and the nonauditor. The DCAA auditor must then evaluate the individual work product for sufficiency. Provide feedback to the contractor/external auditors on the results of our evaluations and the extent of our reliance.

b. Under the CRAG concept (see 3-104.4e), contractor personnel who quali-

¶4-1004.1b.

fy neither as auditors nor experts may be performing oversight functions in a given area. Such activities are part of the contractor's system of internal controls which should be assessed in planning the audit scope.

4-1004.2 Evaluation of Competency, Independence, and Objectivity

a. An initial assessment must be made of the professional competence, independence, and objectivity of the external and internal auditors and nonauditors. The results of this evaluation and documentation will be included in the permanent file, and will be updated only as conditions change.

b. In order to eliminate duplicate inquiries, Headquarters will monitor the following national accounting firms regarding their professional reputations, qualifications, and independence: (1) Arthur Andersen & Co.; (2) BDO Seidman; (3) Coopers & Lybrand; (4) Deloitte Touche; (5) Ernst & Young; (6) Grant Thornton; (7) Kenneth Leventhal & Co.; (8) KPMG Peat Marwick; (9) McGladrey & Pullen; and (10) Price Waterhouse. This is not an exclusive list of public accounting firms that meet the Government Auditing Standard's criteria of professional reputation, qualifications, and independence. Rather it is an alphabetical listing of firms likely to be engaged by major DoD contractors. Regions and Field Audit Offices will be notified by Headquarters if problems with any of these firms are encountered. For other external auditors, determine that they possess the necessary competence and independence by obtaining a representation from the firm that they are (1) members of the AICPA and/or state society in good standing and (2) that the firm is independent under the requirements of the AICPA.

c. When an entity's internal audit department has adopted the standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors, the DCAA auditor may consider that the entity's internal auditors possess the requisite competence and objectivity. Where appropriate, the CAC should coordinate an assessment of adherence to the above standards for the

corporate managed internal audit function. When an entity's internal audit department does not subscribe to these standards, the auditor should consider the following guidance:

(1) When assessing the internal auditors' competence, the auditor should obtain information about such factors as the educational level and professional experience of internal auditors, professional certification and continuing education; audit policies, procedures, and checklists; and supervision and review of internal auditors' activities.

(2) When assessing the internal auditors' objectivity, the auditor should obtain information about such factors as the organizational status, including whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors. In addition, review policies to maintain internal auditors' objectivity about the areas audited, including policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

d. For nonauditors (consultants, experts, specialists, etc.), other than those assisting in the audit, the auditor should consider (1) the professional certification, license, or other recognition of the competence of the specialist in his field, as appropriate, (2) the reputation and standing of the specialist in the views of his peers and others familiar with his capability or performance, and (3) the relationship, if any, of the specialist to the client.

4-1004.3 Evaluation of Work Product

a. To satisfy certain of the requirements discussed in subsections b through d below, access to working papers is required. Accordingly, make arrangements to ensure that working papers will be available. Evaluation of the work product should be based on a comparison of the audit steps the DCAA auditor believes are necessary to those which were performed. If the DCAA auditor concludes that audit program steps essen-

tial to developing evidence to support an unqualified opinion have not been performed, those additional steps must be performed by the auditor before issuing an audit report.

b. When evaluating the work of external auditors, consider whether to conduct additional tests and procedures, such as reviewing the audit procedures they followed and the results of audits they conducted (including their assessment of control risk). Review their audit programs and/or working papers, tests of compliance, and conclusions reached. The auditor may review the documentary evidence in the external auditors' working papers or make supplemental tests of the work conducted.

c. In evaluating the work of internal auditors, the DCAA auditor should examine, on a test basis, documentary evidence of the work performed by the internal auditors. He or she should consider such factors as whether the scope of the work is appropriate, audit programs are adequate, working papers adequately document work performed, conclusions reached are appropriate in the circumstances, and any reports prepared are consistent with the results of the work performed. The DCAA auditor should also perform tests of some of the work of internal auditors. The extent of these tests will vary depending on the circumstances, including the type of transactions, their materiality, and results of prior reviews. These tests may be accomplished by either (1) examining some of the transactions or balances that internal auditors examined or (2) examining similar transactions or balances but not those actually examined by internal auditors. The DCAA auditor should compare the results of his tests with the results of the internal auditors' work in reaching conclusions as to whether DCAA can place reliance on their work.

d. In evaluating the work of nonauditors, consider whether to (1) conduct additional tests and procedures (e.g., reviewing the procedures followed and the results of the work conducted), (2) review the work program, (3) review the working papers, (4) make supplemental tests of the work conducted, and (5) consider the methods or assumptions used.

4-1005 Documentation Requirements

a. Whenever reliance is placed upon the work of others, documentation is required. Reliance must be based upon specific knowledge of the actual work performed and the results obtained. It is not to be based merely upon the assumption or general knowledge that work is to be performed by others.

b. Documentation requirements may include obtaining copies of reports and/or written confirmations of the scope of work performed, the period and costs covered, summary of the results obtained, and audit programs and working papers. In addition, the degree of reliance placed on the work of others must be documented in the DCAA working paper file. In determining the degree of reliance to be placed upon the work of others, apply the guidance for the development and use of evidence and evidential quality contained in 2-306 and 3-104.13.

c. In rendering an audit opinion, consider all work performed, including that performed by others. If work of others is not sufficient in scope and as a result an unqualified opinion cannot be rendered, take steps to obtain additional evidential matter. Where the scope of work performed by other government representatives does not appear to be sufficient in scope, consult with the organization involved to obtain clarification or any additional information available. If reliance still cannot be placed on the work, advise the contractor of the need for additional audit work, how it relates to the work already performed by the other organization, and why it will not duplicate prior government reviews. If additional evidential matter cannot be obtained, then render either a qualified or adverse opinion. See 9-209.2 and 9-209.3.

d. In determining the extent of documentation to be included in the working paper file, the auditor should apply the guidance contained in 4-406. To the extent possible, document reliance on the work of others by reference, notes, or extractions. Where a particularly sensitive or material audit conclusion hinges on other auditors' working papers and referencing/extraction would not be prac-

tical, include appropriate copies in DCAA working papers.

4-1006 Referencing the Work of Others in Audit Reports

4-1006.1 Technical Specialists

As indicated in D-300, refer to and give effect to technical findings and opinions when relied upon. See 10-209.1c(3) and 10-307.9 for suggested audit report comments when incorporating the results of technical review.

4-1006.2 Part of an Audit Performed by Other Auditors

a. The DCAA mission includes providing all contract auditing for the DoD, and providing accounting and financial advisory services to all DoD procurement and contract administration activities (see 1-102). Because DCAA has the ultimate responsibility to express an opinion on contract audit issues, judgments about assessments of inherent and control risk, materiality, sufficiency of tests, and other matters affecting the opinion must be judgments of the DCAA auditor. Recognition of the contractor's participation in self-governance should be included in the DCAA audit report in a manner which does not imply a limitation of scope or a qualification of opinion.

b. Ordinarily you need not make reference to work performed by another auditor if (1) the other auditor works for an organization associated with your organization (e.g., another DCAA office (see 4-

1002a)) and whose work is acceptable to you based on your knowledge of the professional standards and competence of that organization; or (2) the other auditor is retained by DCAA and the work is performed under DCAA guidance and control; or (3) you take steps necessary to satisfy yourself with the other auditor's work; or (4) the work performed by the other auditor is not material to the opinion being expressed.

Once field work is complete, a report using the applicable format in Chapter 10 will be used. In addition, the report may include:

(1) A Background Information paragraph in the narrative section. This paragraph may provide information on another auditor's work, including purpose, scope, and summary of results, and will indicate if the other auditor's report has been provided to the PCO/ACO.

(2) A statement in the Disposition of Audit Results paragraph expressing appreciation for the participation of non-DCAA personnel in the audit effort (see 10-209.4e).

(3) A reference in the explanatory notes accompanying the report exhibits, schedules, and appendixes to the other auditor's scope and findings as they relate to the DCAA reported conclusions. Based upon the complexity and/or the nature of the findings, it may be appropriate to include the other auditor's report as an appendix. However, this should not be done without first obtaining authorization from the other auditor.

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CHAPTER 5

5-000 Review of Policies, Procedures and Internal Controls Relative to Accounting and Management Systems**5-001 Scope of Chapter**

This chapter provides audit guidance on implementing Government Auditing Standards—the second standard of field-

work and SAS No. 55 in performing reviews of contractor accounting and management systems and related internal controls.

5-100 Obtaining an Understanding of a Contractor's Internal Control Structure and Assessing Control Risk**5-101 Introduction**

a. This section outlines the auditor's fundamental requirements and responsibilities for obtaining and documenting an understanding of a contractor's internal control structure and for assessing control risk as a basis for planning related audits.

b. These fundamental requirements and responsibilities apply to each of the contractor's accounting and management systems (see 5-300 through 5-1200) that are used to propose, charge or bill significant costs to government contracts.

c. The audit guidance discussed in sections 5-102 to 5-110 applies primarily to major contractors. This guidance can also be adapted for use at non-major contractors who have internal controls over some of the systems listed in 5-102b below and where audit effort to evaluate those systems is expected to be offset by reduced audit effort on other related audits. The guidance for reviewing internal controls at nonmajor contractors is discussed in 5-111.

b. A contractor's internal control structure can be viewed as a combination of interrelated accounting and management systems. These systems are designed to help ensure that entity objectives are achieved as effectively and efficiently as possible. The relevant accounting and management systems in the contract audit environment and their respective CAM sections are listed below:

- | | |
|---|--------|
| (1) Environment and Overall Accounting Controls | 5- 300 |
| (2) General EDP System | 5- 400 |
| (3) Budget and Planning System | 5- 500 |
| (4) Purchasing System | 5- 600 |
| (5) Material System | 5- 700 |
| (6) Compensation System | 5- 800 |
| (7) Labor System | 5- 900 |
| (8) Indirect and ODC System | 5-1000 |
| (9) Billing System | 5-1100 |
| (10) Estimating System | 5-1200 |

c. It is important to remember that contractor management is responsible for establishing and maintaining an adequate internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objective of the internal control structure is to provide management with reasonable, but not absolute, assurance that:

- (1) Assets are safeguarded against loss from unauthorized use or disposition.
- (2) Transactions are executed in accordance with management's authorization.

5-102 Background Information

a. Government Auditing Standards (the second standard of fieldwork and SAS No. 55) require the auditor to obtain a sufficient understanding of the contractor's internal control structure and to assess control risk to plan the audit and to determine the nature, timing, and extent of tests to be performed. (See CAM 2-305)

- (3) Transactions are recorded properly to permit the preparation of financial statements and government contract cost representations in accordance with generally accepted accounting principles and applicable laws and regulations.

d. With a sound understanding of the critical aspects of each system, the auditor can more effectively and efficiently develop the audit procedures necessary to audit compliance with laws and regulations.

5-103 General Audit Policy

a. It is DCAA's policy that each relevant accounting or management system that has a significant impact on government contract costs be reviewed on a cyclical basis, (e.g., every 2 - 4 years) based on a documented risk assessment. If past experience and current audit risk is considered to be low, a review may be performed on a less frequent basis. If the audit risk is considered to be medium or high, the auditor should work with the ACO and the contractor to correct the deficiencies. When the contractor changes the system, the auditor should give a high priority to the review of the system change as a basis for relying on the system.

b. FAR establishes specific requirements for certain system reviews—budget and planning, compensation, estimating, purchasing and material management accounting systems. See the individual CAM Chapter 5 sections for guidance on the timing of these audits and the procedures for obtaining waivers if the system is considered low risk.

c. In determining the significance of a system, the auditor should carefully consider the relationship of the system to government contracts. For example, if a contractor incurs a significant amount of labor costs which are assigned to government contracts, the contractor's compensation and labor systems would be considered significant. Likewise, if a contractor does not purchase significant amounts of materials for government contracts, the contractor's purchasing and material systems would not be considered significant. (See 3-304.2c)

d. Our review of the contractor's internal control structure and assessment of control risk is documented in the permanent files on the Internal Control Audit Planning Summary (ICAPS) working papers for each significant system (see 3-300). After preparing the initial ICAPS, individual ICAPS forms will be updated after each internal control audit. The adequacy opinion, assessment of risk, and the nature and extent of related audit effort that is summarized on the ICAPS form is also described in the Contractor Organization and Systems section and integrated into the planning and reporting of other financial related audits (see 10-410).

5-104 Audit Objectives

a. The purpose of each internal control audit is to gather sufficient evidence to express an opinion on the adequacy of the contractor's relevant accounting and management systems and the related internal controls for compliance with applicable laws and regulations and contract terms.

b. Our objective in performing internal control audits is to assess control risk to determine the degree of reliance that we can place on the contractor's relevant accounting and management systems and the related internal controls as a basis for planning the scope of other related audits.

c. In those cases where the auditor can rely on the contractor's system, assertions, and/or cost representations, the risk would be considered low. In these cases the auditor should be able to minimize substantive testing.

d. In those cases where the contractor's internal control system(s) are inadequate (in total or in part), expanded testing in other related audits is often needed. However, our emphasis should be on the contractor's relevant accounting and management systems rather than the individual financial related audits.

e. At those contractors with outstanding internal control deficiencies, the auditor should work with the ACO and the contractor to correct the deficiencies rather than to continue performing expanded transaction testing in related au-

dits. When the contractor corrects the deficiency or changes the system, the auditor should give a high priority to the review of the system change as a basis for placing reliance on the system.

f. While the discovery of fraud or other unlawful/improper activity is not the primary objective of any audit, the auditor should be attentive to an condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with CAM 4-700.

5-105 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the scope should include:

- (1) gaining an understanding of the contractor's system internal control structure, including both manual and automated (EDP) activities, which provide reasonable assurance that government contract costs are allowable, allocable, and reasonable in accordance with contract terms, and that material misstatements are prevented or detected and corrected in a timely manner;
- (2) documenting the understanding of the contractor's internal control structure in the working papers and permanent files;
- (3) testing the operational effectiveness of the system's internal controls;
- (4) assessing control risk as a basis to identify factors relevant to the design of substantive tests for other audit effort;
- (5) reporting on the understanding of the internal control structure, the assessment of control risk, and the adequacy of the system for government contracts; and
- (6) adjusting the audit scope of related audits based on the strengths and/or weaknesses of the contractor accounting and management system reviewed.

b. In establishing the scope of audit effort, the auditor should carefully con-

sider the nature and extent of documentation available from prior system reviews, related audit effort, and permanent files. Reliance on this information allows the auditor to better focus current review efforts on areas of greatest risk.

c. The results of prior EDP general internal control audits and applicable functional reviews should be reviewed for related system deficiencies. The following elements should be considered when reviewing internal controls related to individual application systems (see also Appendix C-300):

- (1) The contractor's representation of the application system's internal controls should include a description of system operation and the identification of all related system policies, practices, and procedures.
- (2) The number of employees having access to system data should be reasonable and based on need. Adequate security controls (logical and physical) should be incorporated to limit access to data input, review, and change authorizations. Authority to make changes to data, files, and programs should be limited, logged, and closely monitored.
- (3) Current system flowcharts should describe data input characteristics, internal control points, internal control tables, and output reports. System operation should be verified to the policies, practices, procedures and flowcharts.
- (4) Test system internal controls by tracing selected transactions from the original source documents through data entry, through their interim and final processing stages. Any differences must be resolved with the contractor. Consider using CAATs to expedite the process.

d. Additionally, contractor management has a responsibility to establish and maintain an effective internal control structure. As part of the preliminary audit effort, the contractor should be requested to explain how their system operates, what controls are in place to achieve the identified control objectives, and what efforts have been made to evaluate their continued operation. The auditor should rely to the maximum

extent possible on the contractor's self-assessment, monitoring and testing efforts (see CAM 4-1000, Reliance on the Work of Others).

e. The following paragraphs contain general guidance for reviewing and evaluating contractor accounting and management systems. This guidance is intended to provide the auditor with a framework for performing internal control reviews. However, this framework is not a substitute for professional judgement. Consequently, the auditor should adapt the guidance to respond to unusual or unique situations encountered in their individual audit circumstances.

5-106 Obtaining an Understanding of the Contractor Accounting and Management Systems

a. The first step in reviewing and evaluating the contractor's internal control structure is to obtain an understanding of the accounting or management system being reviewed. This understanding will serve as the foundation for evaluating related internal controls and will allow the auditor to design more effective and efficient audit procedures.

b. To acquire a basic understanding of the accounting or management system being reviewed, the auditor should:

- (1) Review the control objectives and audit procedures listed in the appropriate section of Chapter 5 and the respective audit program and the internal control matrix (available on the DIIS) for the accounting and management system to be audited.
- (2) Review the contractor's system explanation and related documentation; e.g., system policy and procedure manual.
- (3) Review relevant working papers from the permanent files and prior audits.
- (4) Make inquiries of appropriate contractor management, supervisory, and staff personnel.
- (5) Inspect relevant documents.
- (6) Observe actual contractor operations.

c. In addition, the auditor should request that the contractor explain selected aspects of the system to help confirm the auditor's understanding. The auditor should walk-through the system—tracing one or more transactions from initiation through the various processing steps to inclusion in related cost estimates, reports, or billings on government contracts. The auditor should observe actual processing activities and examine related documents to validate the understanding of the system. Selective transaction walk-throughs to confirm the auditor's understanding is an important part of the audit process and should be performed for significant aspects of the system. If the auditor already has a sufficient understanding of the system as a result of prior audit experience, this procedure may not be necessary.

d. The extent of audit effort expended in gaining an understanding of the contractor's accounting and management systems is a matter of auditor judgement. Characteristics that should be considered include:

- (1) the size and complexity of the contractor;
- (2) level of previous experience with the contractor;
- (3) nature and extent of systems documentation;
- (4) the significance of costs proposed, charged, or billed to the government by the system; and
- (5) materiality judgements for specific accounts and transactions handled by the system.

e. Once the auditor has gained an adequate understanding of the contractor's accounting and management systems, that understanding should be documented in the audit working papers and related permanent files. This documentation will typically take the form of system flowcharts, narrative descriptions, and copies of relevant documents and reports. The method(s) used and extent of documentation required are a matter of professional judgement. However, the documentation should provide sufficient information to communicate the auditor's understanding in a clear and summarized manner.

5-107 Determining if Relevant Control Objectives and Related Control Procedures Exist

a. The auditor should identify those control objectives which, if achieved, would provide reasonable assurance that material errors or misstatements would be prevented or detected in a timely manner. Control objectives can be classified into the three general areas:

- (1) financial reporting control objectives which are concerned with ensuring the preparation of reliable financial statements,
- (2) operational control objectives which are concerned with ensuring that the contractor's resources are being used effectively and efficiently, and
- (3) compliance control objectives which are concerned with ensuring that the contractor complies with applicable laws and regulations.

While control objectives in each of these areas can have an impact on contract costs, DCAA auditors generally focus on operational and compliance controls.

b. Relevant control objectives for each contractor accounting and management system are discussed in this section, the specific CAM section and the standard audit program for the individual system. The auditor should become familiar with all relevant control objectives for the accounting and management system to be reviewed prior to initiating the review.

c. The auditor should also identify the control procedures designed and implemented by the contractor to achieve each relevant control objective. Controls may be either manual or automated. In many instances, control procedures will be integrated into the contractor's EDP system. As needed, an EDP audit specialist can assist the auditor in identifying and understanding EDP related controls.

d. Once the auditor has obtained an adequate understanding of the contractor's system, a determination should be made as to whether relevant internal control policies and procedures exist; and whether the effort to test and evaluate those controls would be justified by an equal or greater reduction in related

substantive testing. For example, the auditor should expect that the costs to test and evaluate the contractor's labor accounting controls should be more than offset by the benefits of reduced labor substantive testing (e.g., floorchecks).

e. If the auditor determines that relevant internal control policies and procedures do not exist or that the effort to perform tests of those controls is not justified, no control testing will be performed and control risk would be assessed as "High." This control risk assessment and its background rationale should be documented in the audit working papers.

f. If the auditor determines that relevant internal control policies and procedures can be identified and that the effort to perform tests of those controls is justified, the auditor should plan and perform appropriate tests of those controls.

5-108 Testing Controls

a. Testing controls involves selecting a limited sample of transactions and evaluating whether they were executed in accordance with established policies and procedures. Tests of controls are used to determine if controls are adequately designed to prevent or detect material misstatements in a timely manner, and operating effectively. Tests of controls are necessary to support a control risk assessment other than High.

b. To obtain evidence of the effectiveness of particular internal control policies and procedures, the auditor should perform physical observations, inquiries of appropriate personnel, or inspection of relevant documents. No one specific test is always necessary, applicable, or equally effective in every circumstance. In fact, a combination of these types of tests are often required to provide the necessary level of assurance that controls are working effectively. The type of audit procedures selected depends upon the nature of the control to be tested and the available evidence to review the control. Auditors should use the standard audit programs available on the DIIS and tailor the audit procedures as needed to fit their individual circumstances.

c. The nature of the control influences the type of evidential matter that is available to review the control. For example, if the control provides documentary evidence, the auditor may decide to inspect the documentation. For other controls, such documentation may not be available or relevant. For example, segregation of duties controls generally do not provide documentary evidence. In such circumstances, the auditor may obtain evidential matter about the effectiveness of operation through observation or inquiry.

d. The timing of audit effort and the period covered by the audit should also be considered in selecting the appropriate audit procedures for testing controls. The evidential matter should relate to the audit period and, unless it is documentary evidence, should be obtained during the audit period when sufficient corroborative evidence is most likely to be available. When the evidence relates only to a specific point in time, such as evidence obtained from physical observation, the auditor should obtain additional evidence that the control was effective during the entire audit period. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection of procedures manuals to determine that the control was in operation during the entire period.

e. After determining the nature of audit procedures to be used to test controls, the auditor should then determine the extent of procedures to be performed. This determination is a matter of auditor judgment taking into consideration:

- (1) the information gathered in developing an understanding of the internal control structure,
- (2) the nature of the control to be tested,
- (3) the nature and availability of evidential matter, and
- (4) the contractor's monitoring and testing efforts.

The extent of testing is also significantly impacted by the FAO's total audit experience with the contractor. For instance, the extent of required testing of the estimating system is influenced by the current experience on forward pricing audits. In most instances, where there is

significant proposal activity, the auditors have gained a great deal of knowledge of the estimating system controls during proposal audits.

f. When identified control procedures are accomplished as part of the contractor's EDP operations, the auditor should consider the use of Computer Assisted Audit Techniques (CAATs), such as DATATRAK, SAS, and FOCUS when performing tests of controls. In some instances, the assistance of EDP specialists may be required to perform tests of controls. In these cases, auditors should contact their regional offices to obtain the necessary expertise.

5-109 Assessing Control Risk

a. Control risk is the probability that the contractor's internal control structure will not prevent or detect a material error, irregularity, or misstatement in a timely manner. In assessing control risk, the auditor considers the effectiveness of established control procedures to accomplish stated control objectives. The more effective the control procedures, the lower the control risk.

b. The auditor should assess control risk for each relevant control objective. If the auditor concludes that the relevant internal control structure policies and procedures do not exist or that the audit could be more efficiently performed by expanding substantive testing, then control risk should be assessed as "High." If the auditor has been able to identify relevant internal control structure policies and procedures and performed tests of those controls, the auditor should assess control risk as follows:

High: The relevant control procedures exist but, due to inadequate design or operation, are inadequate to accomplish the control objective on a consistent basis.

Moderate: The relevant control procedures exist but, due to inadequate design or operation, are unlikely to accomplish

Low:

the control objective on a consistent basis.

The contractor's control procedures are likely to accomplish the control objective.

The assessment of control risk for each control objective is summarized on the system's ICAPS working paper (3-300) and translated to needed audit effort on other related audits.

c. The assessment of control risk depends on the nature and significance of the system, the overall control environment, and the auditor's experience and judgement. Assessments of control risk are reported in the systems audit report. Assessments of moderate or high risk should be tied to specific significant deficiencies being reported and recommended corrective actions. (See Chapter 10-400)

d. Significant deficiencies should be discussed with the ACO and the contractor immediately—do not wait until the final exit conference or until the final report is issued to start the resolution process (see 5-110c and 10-400). When possible, significant deficiencies should also be linked to relevant historical data that are available or can be reasonably developed. For example, if the auditor can link estimating system deficiencies to questioned costs on proposal reviews or positive findings on postaward reviews, the importance of correcting the deficiency is more apparent.

5-110 Internal Control Reporting

Reporting on compliance with laws and regulations and on internal controls relative to individual accounting and management systems involves both audits of the contractor's system (e.g., estimating system), as well as, other financial related audits (e.g., individual price proposals).

a. The audit report for each relevant accounting and management system should follow the general guidance in 10-200 and 10-400. The following are the major highlights of the reporting guidance.

(1) The Subject of Audit section should state that the objective for auditing the

specific contractor system and its related internal controls is to determine the adequacy of the system and the contractor's compliance with the internal controls.

(2) The Executive Summary and the Results of Audit sections should present an overall opinion of the system (i.e., adequate, inadequate in part, or inadequate). The executive summary should briefly summarize the major deficiencies and their cost impact. Detailed explanations in a condition/recommendation format will be included in the results of audit section. When deficiencies are reported for estimating and/or purchasing systems, this section should also recommend partial or total disapproval of the system. The results of audit section should state the auditor's control risk assessment [low/moderate/high] and the impact this assessment will have on the nature and extent of audit effort on other financial related audits. Identify the affected audit areas and describe the additional audit effort required.

(3) The Scope of Audit section should explain that the internal control audit includes obtaining an understanding of the internal controls, determining if the controls are adequate and in operation, and assessing control risk to use as a basis for planning the testing necessary in other financial related audits. This section should also identify the system's control objectives covered by the audit and refer to the Contractor's Organization and Systems section that describes the current status of the system along with any needed background information.

(4) If significant deficiencies are noted during the audit, they should be discussed with the contractor and the ACO during the course of the audit and corrective action should be underway before the final audit report is issued. The Statements of Condition and Recommendations in the audit report should comment on the contractor's efforts to correct the deficiencies (see 5-110c).

(5) If the audit identified deficiencies that are not considered to be significant, they should be reported in an appendix to the report entitled "Suggestions to Improve the System".

(6) The status of the contractor's corrective action on prior recommendations should be detailed in the Results of Audit section and summarized in the Contractor's Organization and Systems section.

b. Reports for other financial related audits, (e.g., forward pricing proposals, progress payment requests, and annual incurred cost audits) should follow the general guidance in Chapter 10. The report should refer to the relevant accounting and management systems report(s) and the internal control assessments used to plan the audit.

(1) At those contractors with defined internal control structures, the Scope of Audit section should:

- (i) list the system(s) that provide for compliance with laws and regulations for the specific audit area,
- (ii) describe how assessed system(s) control risk was considered in determining the scope of audit, and
- (iii) refer to the Contractor's Organization and Systems section that describes the current status of the system(s).

(2) The Contractor's Organization and Systems section should:

- (i) reference the last audit report and the current opinion on the overall system,
- (ii) show the current assessment of control risk, and
- (iii) list any outstanding internal control deficiencies and the current status of those deficiencies.

(3) At smaller contractors that do not have defined internal control structures or nonmajor contractors where it was not beneficial to review the structure, the scope paragraph should state that fact and state that as a result, control risk was assessed as high.

c. Significant internal control weaknesses identified during an audit require immediate action intended to expedite the resolution process and to protect the government.

(1) If a significant internal control deficiency is encountered during an internal control audit, the deficiency should be discussed with the contractor, the cognizant ACO, and the CAC as soon as possible so as to expedite the resolution

process. Do not wait until the final exit conference or the issuance of the audit report to convey such findings.

(2) The internal control audit report should describe the deficiency, its estimated cost impact, the contractor's efforts to correct the deficiency and increased audit effort in other related audits needed to mitigate the internal control weakness.

(3) If a significant internal control deficiency is encountered during other related audits, a separate flash report should be issued. The flash report should include an estimate of the cost impact of the internal control weakness to the extent possible. The auditor should work with the ACO and the contractor to correct the deficiency rather than performing expanded testing in a particular audit area. When the contractor corrects the deficiency, the auditor should give high priority to the review of the system change as a basis for placing reliance on the system.

(4) If the contractor does not take timely corrective action to resolve the deficiency, the auditor should take steps to protect the government's interest. The auditor should coordinate with the ACO and notify the contractor of the intent to suspend or disapprove costs related to the weakness. For example, reports on price proposals should question the related costs and contain an appropriate opinion and/or recommendation (see 9-200). If internal control deficiencies affect billings to the government, the auditor should suspend any appropriate costs on public vouchers (see 6-900) or recommend to the ACO reductions on progress payment requests (see 14-206).

5-111 Reviewing Internal Controls at Nonmajor Contractors

The process for obtaining an understanding of a contractor's internal control structure and assessing control risk at nonmajor contractors is accomplished by using the Survey of Contractor's Organization, Accounting System, and System of Internal Controls (SHORTICO) which is available on the DIIS. If the nonmajor contractor has some of the internal control systems listed in 5-102b that generate

significant costs, the auditor can use the CAM guidance, the audit program related to the system, and the SHORTICQ to review the internal controls.

5-111.1 Understanding and Evaluation of Internal Control Structure

a. The SHORTICQ should be used to document the understanding of the internal controls at nonmajor contractors with ADV between \$5 and \$70 million. (MAAR#1). The SHORTICQ may also be used for contractors with ADV less than \$5 million, or alternative procedures may be used provided they adequately document the required understanding of the internal control structure. Alternative approaches for contractors with less than \$5 million ADV include the use of a narrative format similar to the appendix on the contractor's accounting system discussed in 10-506.1.

b. The control environment reflects management's overall attitude, awareness and actions concerning the importance of control and its emphasis in the company. To gain an understanding of the control environment, the auditor should consider the information in the SHORTICQ, particularly Part A, or information from other identified alternative sources.

c. The auditor should also obtain an understanding of the accounting system and specific control procedures for each major cost element (i.e., labor, indirect costs, and purchased services and material). The auditor should consider the information contained in the SHORTICQ, particularly Parts B and C for labor, Parts B and E for indirect costs and Parts B and D for purchased services and material.

d. Based on the information obtained in b. and c. above, the auditor should summarize the understanding of the control environment, accounting system and control procedures. The summary may be in the form of a narrative explanation which includes an identification of significant internal controls. The form and extent of documentation is influenced by the company's size and the complexity of the internal structure.

5-111.2 Assessment of Control Risk

a. The purpose of evaluating the internal control structure is to assess the contractor's level of control risk for determining the nature, timing and extent of transaction tests in incurred cost audits. For example, if the auditor determines that internal control systems do not exist because of the company's size or the internal control systems are so deficient that it cannot be relied on, the auditor would assess the control risk as high.

b. If, on the other hand, the auditor determines that specific control procedures exist and have been implemented, the auditor may decide to perform tests of the effectiveness of the specific controls in order to limit the amount of transaction testing in the areas or accounts impacted. The auditor may also rely on previous systems audits if the reviews adequately evaluated the effectiveness of specific control procedures which would effect the auditor's assessment of control risk.

c. To assess control risk at less than high, which could result in reduced substantive testing, requires that the contractor have control procedures and that these procedures have been tested and are working. Control procedures represent independent verifications that management has established to provide assurance that the accounting system is properly identifying and segregating costs; and, that costs claimed on government contracts are allowable, allocable, and reasonable. The testing of control procedures is generally a time sensitive audit which needs to be performed during the year the costs are incurred. If the control procedures were not tested, control risk would be assessed as high.

d. Since smaller contractors do not generally have control procedures such as segregation of duties or independent verifications, control risk is usually assessed as high. If control risk is assessed as high, substantive tests would be required for significant and sensitive accounts. Control risk is also generally assessed as high if the internal control policies and procedures are ineffective or it would be more efficient to perform substantive tests

rather than to test the contractor's compliance with the policies and procedures.

5-111.3 Reporting

The auditor's reporting on the review and evaluation of internal controls at nonmajor contractors is usually included as part of the report on the annual incurred cost audit.

a. The Scope of Audit section should identify the internal control structure and the assessment of control risk that the auditor considered in planning the audit. This section should also describe any significant accounting system deficiencies that have a material impact on the incurred cost submission and the audit.

b. The Contractor's Organization and Systems section should describe the con-

tractor's accounting system as well as the current status of any outstanding accounting system deficiencies and their cost impact (see 10-410).

c. If a significant accounting system deficiency (e.g., the contractor does not identify and segregate unallowable costs or fails to prepare timecards) is encountered during the incurred cost audit, do not wait—issue a separate flash report and coordinate with the ACO and the contractor to expedite the resolution process (see 5-110c). When the incurred cost audit report is issued, the cost impact and current status of this deficiency should be described in the Results of Audit and the Contractor's Organization and Systems sections.

5-200 Section 2 — Preaward Surveys and Adequacy of Accounting Systems for Contractual Requirements**5-201 Introduction**

This section provides guidance for performing (1) preaward accounting system and financial capability surveys and (2) reviews to determine if a contractor's accounting system and control procedures are adequate to meet the requirements of Department of Defense Directive 2140.2 and DFARS 270 and 252.270-7000 for the payment of nonrecurring cost recoupment charges to the government. A pro forma preaward survey audit program and accounting system survey for nonmajor contractors is on the FAO DIIS subsystem under file name APSYSTEM.

5-202 Preaward Surveys

a. A preaward survey is an evaluation, usually made by the cognizant contract administration office, of a prospective contractor's ability to perform a proposed contract. Such surveys may cover technical, production, quality assurance, financial capability, accounting system and other considerations. DCAA's role in a preaward survey is normally limited to assessing a contractor's financial capability to perform a prospective contract (see 5-202.1) and/or the adequacy of a contractor's accounting system to accumulate cost information required by a contract (see 5-202.2).

b. Treat requests for DCAA assistance on preaward surveys as demand assignments. An untimely response to such requests could delay the award of a contract.

5-202.1 Preaward Financial Capability Survey

a. The objective of the survey is to determine if the prospective contractor has adequate financial resources, or access to them, to perform a contract. Page 1 of Standard Form 1407 "Preaward Survey of Prospective Contractor Financial Capability" (see FAR 53.301-1407) can be used to collect data required to conduct the survey.

b. When a request for a preaward survey is not specific as to the type of financial data to be evaluated, contact the requester for clarification. See 14-300 for additional guidance on procedures to follow in performing financial capability surveys.

5-202.2 Preaward Accounting System Survey

a. A preaward accounting system survey is made at the request of a contracting officer to determine the adequacy and suitability of a contractor's accounting system and practices for accumulating costs under a prospective government contract. It is usually requested as part of an overall preaward survey of a contractor conducted by a contract administration office under FAR/DFARS 9.106/209.106 (see 5-202). Audit scope under a preaward accounting system survey should normally be limited to those procedures essential to reach an informed opinion on information needed by the acquisition office to award and provide for administration of the contract. It is not normally necessary to conduct an in depth evaluation of the overall accounting system (see 9-302). Be responsive, however, to the request for audit. Standard Form 1408 "Preaward Survey of Prospective Contractor Accounting System" (see FAR 53.301-1408) should normally be used for these surveys.

b. If a prior accounting system survey has been performed and is relatively current, it should serve as the basis for the current survey. If complete and current data are not available, perform a survey of sufficient scope and depth to evaluate the suitability of the contractor's accounting system for costing and administering the contemplated contract. Place special emphasis on the ability of the accounting system to generate the specific cost information required under the anticipated contract and on inequities which might occur if the prospective contract were executed. Subsequent cost determination will be facilitated if there is a workable relationship between con-

tract provisions and the contractor's system. This preaward examination should disclose the extent to which they are compatible. When appropriate, the survey should disclose whether the system will provide reasonable data for projection of costs to complete a contract. The equity and consistency of direct charging as generally applied by the contractor and as it is intended to be applied to the proposed contract should be determined. If it is not clearly stated in the request as to the type of contract contemplated, the auditor should call the requester for clarification. When a cost-type contract is contemplated, the auditor should give consideration to whether reimbursement of indirect costs should be provided on an actual or negotiated (e.g., ceiling rate) basis. Also comment on any particular or unusual items of cost which should be made the subject of advance agreements or special contract clauses (See FAR 31.109).

5-202.3 Audit Reports

Audit reports should be responsive to the specific needs identified by the audit request and in discussions with the requester. The audit report scope paragraph should identify the specific procedures followed. Audit reports should also provide sufficient information (e.g., financial exhibits and schedules) to support audit conclusions. (See 10-400 for accounting system report format and 10-1200 for additional guidance on the financial capability format).

5-203 Recoupment of Nonrecurring Costs on Sales of U.S. Products and Technology

5-203.1 Background

a. DoD Directive 2140.2, "Recoupment of Nonrecurring Costs on Sales of U.S. Products and Technology," and DFARS Subpart 215.70, "Recoupment of Nonrecurring Costs," (prior to 24 March 1993) establish policies and procedures for the recovery of nonrecurring cost from DoD contractors who sell or license defense items developed with DoD appropriations or funds (and, in special cases, customer funds) or use

technical data packages to manufacture items sold commercially to a foreign government, international organization, foreign commercial firm, or private party for military purposes. DoD Focal Points (see DFARS 215.7003 prior to March 1993) maintain a central data base on established charges. In addition, Appendix D to DoD Manual 7290.3-M lists recoupment charges applicable to both major and non-major defense equipment. A copy of the appendix was provided to each field audit office.

5-203.2 Contractor Responsibilities

a. For sales made prior to 7 October 1992, contractors are required to reimburse the government for nonrecurring costs on all items developed under contracts that contain DFARS clauses 252.215-7004, 252.270-7000, or 252.270-7001.

b. For sales made after 6 October 1992, DFARS clauses 252.215-7004, 252.270-7000, and 252.270-7001 apply only to sales of major defense equipment made under the foreign military sales program, as covered by the Arms Export Control Act.

c. For contracts awarded after 24 March 1993, recoupment required by the Arms Export Control Act will be handled directly between the DoD and its foreign military sales customer.

5-203.3 Auditor Responsibilities

a. The auditor has the responsibility for determining if a DFARS clause for the recoupment of nonrecurring costs is in effect on DoD contracts subject to DCAA audit. If any DoD contract under audit contains the DFARS clause 252.270-7000, 252.271-7001, or 252.215-7004, the auditor must ensure that an evaluation of the contractor's internal controls includes an analysis of the control procedures established to assure compliance with the DFARS requirement to notify the government, pay nonrecurring cost recoupment charges, as well as other responsibilities specified in the applicable DFARS clause, subject to the limitations contained in 5-203.2.

b. Contract administration offices may request DCAA to verify whether development of commercial items was fully or

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partly funded by charges against DoD contracts. If an audit of a price proposal, claim for incurred cost or some other audit area discloses contractor noncompliance with the requirement to pay a nonrecurring cost recoupment charge, an audit report shall be issued promptly to

the cognizant contracting officer. Send a copy to the Deputy Assistant Secretary of Defense (Management Systems), Room 3E825, The Pentagon, Washington, DC 20301-1800 and also to DCAA Headquarters, Attn: OAD. |

5-300 Section 3 — Review of Environment and Overall Accounting Controls

5-301 Introduction

a. This section provides specific guidance for reviewing the contractor's control environment and overall accounting controls and assessing control risk. An understanding of the control environment will serve as a framework for evaluating the overall effectiveness of the internal controls in the contractor's other accounting and management systems (i.e., labor, material, purchasing, etc.). Overall accounting controls include the contractor's controls to assure it remains financially capable to perform on government contracts, and it maintains a current description of the accounting system, including a current, accurate, and complete disclosure statement (if CAS covered) and a current chart of accounts.

b. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

5-302 Background Information

a. The control environment has a pervasive influence on the way business activities are structured, objectives established, and risks assessed. It also influences control activities, information and communication systems, and monitoring activities. Effectively controlled entities strive to have competent people, instill an enterprise-wide attitude of integrity and control consciousness, and upper management's commitment to ethical business practices and behavior. In evaluating the effectiveness of a contractor's control environment, the auditor should consider whether:

- (1) Management conveys the message that integrity and ethical values cannot be compromised.
- (2) The Board of Director's and Audit Committee are sufficiently independent from management to constructively challenge management decisions, act effectively on external audit communications and recommendations, and take an active

role in ensuring that an appropriate "tone at the top" exists.

- (3) The organization structure provides an overall framework for planning, directing, and controlling operations.
- (4) Management ensures that appropriate responsibility and delegation of authority is assigned to deal with goals and objectives.
- (5) Adequate financial resources exist to perform on government contracts.

b. Accounting and management systems vary among companies according to organizational size and structure, type of product or service, personal preferences of corporate officials, and other influences. Most systems, regardless of complexity, contain elements of electronic data processing (EDP) for recording, processing, analyzing, and reporting related accounting data. However, in order to be effective, any system must be soundly organized and facilitate the proper accumulation and allocation of contract costs. In evaluating the effectiveness of a contractor's accounting controls, the auditor should consider whether systems:

- (1) are well designed, and reflects adequate consideration of automated controls
- (2) provide for the assignment of costs to cost objectives in accordance with applicable government contract rules and regulations
- (3) account for costs in accordance with Generally Accepted Accounting Principles

5-303 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of relevant contractor accounting and management systems and related internal controls.

b. If the audit risk assessment indicates that only certain parts of a contractor's environment and overall accounting controls are subject to medium or high risk, only these risk areas would require a complete review. For example, a major change in billing system software may

require a review of the internal audit department's participation in the development, modification and implementation of significant systems. Areas of little or no risk need not be reviewed so long as the low risk determination is adequately documented.

5-304 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the system's control environment and overall accounting controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The adequacy of contractor's environment and overall accounting controls affect the adequacy of other accounting and management systems and related internal controls. As a result, the auditor needs to understand the environment and overall accounting controls in order to effectively review the internal control policies and procedures in other relevant contractor systems.

5-305 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The pervasiveness of EDP activities in most organizations requires that the auditor consider the results of EDP systems audits relative to the contractor's control environment.

c. The following paragraphs contain guidance for reviewing and evaluating the critical control objectives relating to the contractor's environment and overall accounting controls. These objectives, if achieved, should provide a basis for reducing the scope of related contract audit activity. This guidance is intended to provide the auditor with a framework for evaluating the contractor's system. However, this framework is not a substitute for professional judgment. Consequently, the auditor should adapt the guidance to respond to unusual or unique

situations encountered in varying audit environments.

5-306 Integrity and Ethical Values

Management should convey the message that integrity and ethical values cannot be compromised, and employees should receive and understand that message. Management should continually demonstrate, through words and actions, a commitment to high ethical standards.

5-306.1 Codes of Conduct

a. The contractor should establish and maintain a written code of conduct addressing ethical business practices, conflicts of interest, and expected standards of ethical and moral behavior. This code of conduct should cover dealings with customers, suppliers, employees, and other parties. In evaluating the adequacy of the contractor's code of conduct, consider whether:

- (1) Codes are comprehensive, addressing conflicts of interest, illegal or other improper payments, anti-competitive guidelines, insider trading, etc.
- (2) Codes are periodically acknowledged by all employees.
- (3) Employees understand what behavior is acceptable or unacceptable, and know what to do if they encounter improper behavior.
- (4) A written code of conduct exists. If not, the management culture should emphasize the importance of integrity and ethical behavior. This may be communicated orally in staff meetings, in one on-one interface, or by example when dealing with day-to-day activities.

5-306.2 Management Intervention

Policies and procedures should provide guidance on the situations and frequency of management intervention in the collection, processing, and reporting of accounting data and transactions, and the types of approvals and documentation required. For example, consider whether:

- (1) management has provided guidance on the situations and frequency with which intervention may be needed

- (2) management intervention is controlled, well documented, and explained appropriately
- (3) deviations from established policies are investigated and documented

5-306.3 External Influences

External influences heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may prompt management to establish specific internal control structure policies or procedures. The auditor should be alert for external factors which may have an influence on management's attention to internal controls. For example, consider whether:

- (1) the contractor's internal control structure is subject to external reviews by organizations other than DCAA
- (2) any access to records problems exist which may adversely impact the ability to assess the contractor's internal controls
- (3) any DCAA Form 2000s have been issued or current investigative activity indicates weaknesses in established internal controls

5-306.4 Self-Governance

Management should place an emphasis on establishing and maintaining an effective system of internal controls and self-governance and should not condone signs of inappropriate practices. Management must continually communicate the importance of a strong internal control system. For example, consider whether management:

- (1) has established a formal self-governance program
- (2) openly communicates the importance of internal controls and has provided for periodic review of internal controls
- (3) takes appropriate remedial action in response to departures from approved policies and procedures or violations of established codes of conduct

5-307 Board of Directors or Audit Committee

The Board of Directors and the Audit Committee should be sufficiently independent from management to challenge management's decisions, act effectively on external audit communications and recommendations, and take an active role to ensure an appropriate upper management's accountability for integrity and ethical behavior. An active and effective board, or committees thereof, provide an important oversight function and, because of management's ability to override system controls, the board plays an important role in ensuring effective internal control.

5-307.1 Independence

The Board of Directors and/or Audit Committee should be composed of independent members and be actively involved in significant decisions. For example, consider whether:

- (1) the Board of Directors has a significant number of members who are not officers or employees of the contractor
- (2) the board constructively challenges management's planned decisions, e.g., strategic initiatives and major transactions, and probes for explanations of past results (e.g., budget variations)
- (3) board committees are used for matters requiring more in-depth or directed attention
- (4) a process exists for informing the board of significant issues
- (5) the compensation committee approves all management incentive plans

5-307.2 Internal Audit Department

The internal audit department should be functionally and organizationally independent and sufficiently removed from political pressures to ensure that they can conduct their audits objectively and can report their findings, opinions, and conclusions without fear of repercussion. For example, consider whether:

- (1) the internal audit department reports to an individual with suffi-

cient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action relative to audit recommendations

- (2) the internal audit department has regular communications with the Board of Directors or Audit Committee
- (3) the internal audit department participates in the development, modification, and implementation of significant accounting systems

5-307.3 External CPA Management Letter on Internal Controls

Management should effect prompt correction of deficiencies noted in external CPA's management letter on internal controls. Responsiveness to external auditor notifications of internal control weaknesses can provide important insight to management's overall commitment to maintaining an effective internal control structure. For example:

- (1) the contractor's external auditor's have reported any internal control weaknesses and, if so, the status of the contractor's corrective action. The auditor needs to obtain the management letter to make this determination
- (2) recent changes in external auditors, if any, indicate a disagreement on accounting or internal control issues

5-308 Organizational Structure

The organizational structure provides the overall framework for planning, directing, and controlling operations. The organizational structure shouldn't be so simple that it cannot adequately monitor the enterprise's activities nor so complex that it inhibits the necessary flow of information. Executives should fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions.

5-308.1 Form and Nature

The form and nature of the organization should be well defined, including the

assignment of management functions, reporting relationships, and authority and responsibility. For example, consider whether:

- (1) the contractor maintains formal organization charts which clearly define lines of authority and responsibility
- (2) responsibilities and expectations for the entity's business activities are communicated to the executives in charge of those activities
- (3) departments providing critical services (e.g., Information Services) report at a sufficiently high organizational level to reasonably preclude undue influence from other departments

5-309 Assignment of Authority and Responsibility

The assignment of responsibility, delegation of authority, and establishment of related policies should provide a basis for accountability and control, and set forth individuals' respective roles.

5-309.1 Written Policies and Procedures

a. Written policies and procedures should adequately address assignment of responsibility and delegation of authority to deal with organizational and departmental goals and objectives, regulatory requirements, and information systems and authorizations for changes to these systems. For example, consider whether:

- (1) authority and responsibility are assigned to employees throughout the entity
- (2) responsibility for decisions is related to assignment of authority and responsibility
- (3) proper information is considered in determining the level of authority and scope of responsibility assigned to an individual

5-310 Financial Capability

Management should periodically evaluate financial resource requirements to ensure that they are adequate to perform on government contracts. Contractors who fail to properly manage their financial resources subject the government to

increased risk that contract performance will be adversely affected. The review of the contractor's financial capability is discussed in 14-300.

5-310.1 Policies and Procedures

Written policies and procedures should require regular evaluations of financial conditions in order to anticipate and avoid adverse conditions. Adverse financial conditions can have a significant impact on the contractor's ability to perform on government contracts. Therefore, the contractor should regularly assess its financial condition and take steps to avoid potential problems.

5-310.2 Assessment of Accounts Receivable/Payable

The contractor should conduct periodic assessments of accounts payable and accounts receivable including analysis of accounts payable aging and the collectability of accounts receivable. Effective cash flow analysis is dependent upon the proper assessment of cash inflows (accounts receivable) and cash outflow (accounts payable). The contractor should prepare detailed assessment of both the debit and credit balances for each of these accounts on a regular basis to ensure that cash flow projections are based on sound financial information.

5-310.3 Debt Payment

The contractor should conduct periodic assessments to ensure that it is meeting debt payment schedules and is in compliance with other loan covenants. Failure to meet debt repayment schedules can have a negative impact on the contractor's ability to perform on government contracts. Therefore, it is important that the contractor periodically assess the status of its debt repayment efforts to ensure that they are adequate.

5-310.4 Cash Flow Projections

The contractor should regularly perform short and long term cash flow projections. The contractor should assess both current and future financial conditions in order to ensure that adequate financial resources are available to support the performance of government con-

tracts. For example, the auditor should consider whether:

- (1) the contractor prepares cash flow analyses for current and future periods to ensure that adequate resources are available to meet current and projected cash flow requirements
- (2) the contractor establishes formal plans to meet anticipated cash flow deficiencies

5-311 Accounting System

The contractor's accounting system consists of methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The accounting system should be well-designed to provide reliable accounting data and prevent misstatements that would otherwise occur.

5-311.1 System Description

The contractor should establish and maintain a written description of its accounting system which clearly identifies the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. For example, consider whether the contractor:

- (1) maintains a current, accurate, and complete chart of accounts
- (2) has flow charts, narrative descriptions, or other explanations of how information is processed through the accounting system, including the EDP system, from initiation of transactions to reporting of the transactions in the financial records. This should include identification and purpose of all transactions, schedules, tables, files, overrides, and reports generated and processed by the system.
- (3) has clearly identified personnel responsible for preparing, reviewing, modifying, and approving accounting transactions.

5-311.2 Disclosure of Cost Accounting Practices

The contractor should establish and maintain a current, accurate, and complete description of all cost accounting practices which impact government contracts. Normally contractors who have approved CAS disclosure statements have complied with this requirement. Contractors should establish policies and procedures to ensure that disclosed cost accounting practices are current, accurate, and complete. In addition, the con-

tractor should have policies and procedures to ensure that all changes in cost accounting practices are properly disclosed to the government along with the related cost impact.

5-312 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

5-400 Section 4 — Review of Contractor Electronic Data Processing (EDP) General Internal Controls

5-401 Introduction

a. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

b. This section provides guidance for reviewing general EDP internal controls applicable to centralized data center operations, distributed processing environments, and local/wide area networks (LAN/WAN). The contractor's EDP general internal controls establish the control environment within which all computerized accounting and management systems operate. See Appendix C for further guidance on reviewing EDP systems.

c. The guidance should be applied selectively, giving consideration to the unique aspects of the in-place data processing system and areas judged to be relatively high risk.

5-402 Background Information

a. EDP general internal controls are comprised of the following elements:

- (1) organization and operational controls
- (2) systems development and documentation controls
- (3) hardware and systems software controls
- (4) access controls
- (5) data and procedural controls

b. Weaknesses in EDP general internal controls often have pervasive effects on contractor overall accounting operations. When EDP general internal controls are weak or absent, the auditor must consider the effect of these control deficiencies in the evaluation of EDP application/functional controls. These type internal controls apply to specific applications or functions such as the purchasing system or labor accounting system. For example, internal controls should require proper authorization of source documents such as purchase orders or labor data recording prior to input to the EDP system.

c. EDP general internal controls could vary significantly between contractor locations. Size of the contractor is a major factor influencing the level of general internal controls the auditor may find installed. Larger contractors will generally have more extensive internal controls in operation than smaller contractors. The auditor must be prepared to assess the level of compensating controls at smaller contractor sites since it is expected that optimum control procedures will not be in effect.

d. Larger contractors generally have most general internal controls in-place. However, large contractors having geographically dispersed locations may exhibit adequately documented internal controls, but may not consistently enforce the controls throughout the dispersed environment.

e. Contractors may not dedicate a data center to service the EDP requirements of a single location. Sizable contractors may have a data center supporting a single location, or a centralized data center that services several geographically dispersed company locations. Some contractors may use outside commercial EDP services instead of maintaining their own data centers. The auditor must determine the extent of the contractor's EDP resources when planning and defining the scope of the audit.

5-403 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. EDP general internal controls meet the definitions of "record" and "data" contained in FAR 52.215-2, Audit - Negotiation, and FAR 52.214-26, Audit - Sealed Bidding. The applicability of these FAR sections are agreed to by contractors when submitting price proposals and executing contracts with DoD components. These contract clauses give the auditor the right of access to contractor records, including EDP internal control

data, after contract award. Refer to Chapter 1-504, Access to Contractor Records.

5-404 Audit Objectives

The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the EDP system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-405 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The auditor should consider any EDP related outstanding deficiencies identified in other accounting and management system audits. The nature of such deficiencies may affect the scope of the EDP general control audit. For example, a labor accounting system deficiency involving changes to the labor system may affect the current review of software modification procedures and controls.

c. The following sections contain general guidance for the review and evaluation of general EDP controls. This guidance gives the auditor a framework for the audit. However, this guidance is not a substitute for professional judgement. The auditor should adapt this guidance to fit individual audit circumstances.

5-406 Independent Management Reviews

a. Most organizations are subject to dynamic change, therefore, the internal control structure should include the requirement for periodic independent management review of internal controls. Typically, these reviews are performed by the internal audit function or external auditors engaged by the organization. The internal audit function or external auditors should possess sufficient technical competence, independence, and authority to conduct objective reviews of EDP

internal controls, and to submit reports on its findings and recommendations for improvement in all functional areas of the organization's information services environment. A consequence of these reviews is the obvious requirement for follow-up and resolution of identified deficiencies. Refer to Chapter 4-1000, Relying on the Work of Others, for additional guidance.

b. Many factors, including changes in computer center equipment, systems software, information systems personnel, user requirements, and the general business environment can weaken established internal controls. However, changes in the same elements can also strengthen internal controls and eliminate the necessity for some redundant controls and their associated cost. Periodic management reviews should be designed to identify any new requirements and to eliminate redundant controls. These reviews should be scheduled on a recurring basis.

c. In addition to independent management reviews, the quality of the services performed by a contractor's Information Systems (IS) Department should be ensured by the establishment of a separate function within the department devoted to maintaining established standards of quality. Quality policies, practices, and procedures should be available and should clearly define the responsibilities of the quality function. Moreover, review plans, schedules, and measurements should be developed, standardized, and maintained by the quality function to establish criteria for the guidance of assigned personnel. Reports on the results of quality reviews should be prepared and submitted to user management and IS management.

5-407 Organization

The effectiveness of most internal control procedures is dependent on the actions of personnel responsible for implementation of the controls. An organization's structure is a significant control factor. A basic accounting internal control is the segregation of duties among those who:

(1) initiate and authorize transactions

(2) have custody of the asset acquired
(3) record accountability for the asset
The concept of segregation of duties is universal and must be maintained in order to achieve satisfactory internal control. The data processing function is subject to the same internal control criteria, both as an organizational element and as a functional department.

5-407.1 Independent Structure

a. Organizational and administrative controls are essential operational elements of most enterprises. The nature and extent of these controls depend on such factors as corporate culture, strategic importance of departments or divisions, legal requirements, assets employed, and a variety of other influences. Traditional organizational structures are based on the separation of functions by establishing independent departments reporting to senior officials or directors. For example, the finance department and the accounting department are typically independent, equal entities reporting to different officials. This organizational independence is viewed as a mechanism to prevent or minimize the opportunity for the perpetration and concealment of material irregularities and serves as a cross-check to disclose potential errors. In this traditional organizational structure, each department usually accomplished their own clerical and data processing activities. However, with the advent of centralized EDP centers, many of the traditional departmental data processing activities were transferred to a separate centralized functional and organizational entity, the Information Systems (IS) Department.

b. Centralization of data processing activities has resulted in the concentration of many system processing steps into one department. The concentration of traditional accounting data along with operating data is common. Such concentration is referred to as integration, in which related elements of different data processing activities are combined into common and coordinated procedures and a logical work flow. Integration assists in the preparation of desired managerial reports from a single record of each business transaction, and all transactions

are processed in a unified system. The centralization of data processing into one department emphasizes the importance of proper control of the data processing center itself.

c. The IS Department should be positioned in the organizational structure to enable it to meet established overall objectives and to ensure operational independence from user departments. Therefore, the contractor should be able to demonstrate that the IS Department is not subjected to undue influence from other departments having the authority to initiate or authorize transactions. The EDP function should be positioned within the organization at a level sufficiently high to ensure that its independence is not compromised. At small contractors, the IS Department might not report directly to senior management. In this situation, the contractor should be able to demonstrate that the level of management involved is sufficient to preclude the perpetration and concealment of material errors and misstatements.

d. The contractor should be able to show that the IS Department exercises adequate control over the data processed, and that they do not:

- (1) initiate data for input
- (2) have custody of or control non-EDP assets
- (3) have the authority to originate master file changes

The EDP function should not correct errors unless the errors are generated as a result of electronic data processing and they should also be prohibited from initiating or authorizing transactions.

5-407.2 Segregation of Duties

a. Just as there should be organizational independence between functions, there should also be independence or segregation of functions or duties within the IS Department. Management should provide for a segregation of incompatible duties within the IS Department. Examples of incompatible duties include:

- (1) systems development and computer operations
- (2) computer operations and data control
- (3) database administration and systems development

b. Application development personnel having control over changes made to application systems and their eventual implementation, should not have access to the computer resources which process those systems. These type controls help prevent the introduction of unauthorized changes to the system. Likewise, computer center operations personnel who actually operate the computer system hardware should not have access to application systems libraries. This type control helps prevent unauthorized changes from being made to application software. Most large corporations employ some type of database management system (DBMS) directed by an administrator responsible for the control of database elements introduced into the system. Database administrators (DBA) should not have access to application systems which access and process the data in the system.

Segregation of duties:

- (1) provides an effective cross-check of the accuracy and propriety of changes introduced into the systems
- (2) reduces the opportunity for computer operations personnel to implement revisions without prior approval and checking
- (3) minimizes access to the equipment by nonoperating personnel and other people who have knowledge of the system
- (4) improves efficiency because the capabilities, training, and skills required in carrying out these activities differ greatly

c. The contractor should be able to show through IS Department organization charts and position descriptions that duties and responsibilities are adequately segregated. Small contractors may have organizational structures where some incompatible duties and responsibilities may occur. The contractor may be able to demonstrate the existence of compensating controls which mitigate these problems. For example, data processing functions might be under the cognizance of the finance department. Under these circumstances, the contractor should ensure that adequate controls are installed which will preclude undue influence on data processing operations.

5-408 Software Acquisition, Development and Modification

a. Electronic data processing has substantially reduced the time available for reviewing transactions before the transactions are entered into an organization's records. Consequently, in poorly controlled systems, the opportunity for detecting transaction errors before they have an impact on operations may be reduced, especially in the case of real-time and database systems where records are subject to immediate update. To help provide reasonable assurance that software systems contain adequate controls and security, organizations should employ a standardized methodology when acquiring, developing, and modifying either systems software or applications software. The goal of this methodology should be to achieve:

- (1) system effectiveness
- (2) economy and efficiency
- (3) data integrity
- (4) resource safeguarding
- (5) compliance with laws and regulations

b. The methodology to effect software acquisition and/or development can vary significantly among contractors and is influenced by many factors such as:

- (1) size
- (2) type of business
- (3) organizational structure
- (4) current business environment

Senior management should issue a written policy statement establishing a standard System Development Life Cycle (SDLC) methodology as a means for structuring and controlling the process of acquiring, developing, and maintaining systems and application software. The SDLC methodology should include the following controls:

- (1) definition of requirement
- (2) participation of appropriate personnel
- (3) software documentation
- (4) validation, verification and testing
- (5) final management approval

c. Software development begins when the need for an automated solution to a problem is identified and validated. Definition of requirements produces the func-

tional requirements and begins the detailed planning for the development of an operable system. It is critical that internal control and specific security requirements be identified during this process. Requirements definition should include:

- (1) internal audit plan
- (2) project plan
- (3) functional requirements document
- (4) functional security and internal control requirements document
- (5) data requirements document
- (6) description of sensitive and critical data

d. It is good practice to require participation of cognizant personnel in the development process to provide reasonable assurance that internal controls, security, user, and organizational requirements are addressed. Participants should include:

- (1) IS management
- (2) systems security officer
- (3) internal auditors
- (4) users
- (5) quality assurance personnel.

e. The development methodology should incorporate standards for systems, program, and user documentation. Good documentation policies and procedures facilitate program modifications, staff training, and establish a starting point for a review of control procedures. System documentation should include a description of the system, information flow, various programs required, interrelationship with other systems, computing resources required, and operating environment. In addition to narrative, the documentation should include flowcharts depicting system operation. Program documentation should include a detailed narrative explaining the objective of the program. It should contain detailed narratives and flowcharts of the processes incorporated into the program to accomplish data processing objectives.

f. An effective validation, verification, and test plan is an essential part of any development and program change methodology. It helps maintain the integrity of the applications by assuring that only authorized modifications, revisions, or changes are made. The plan must provide for the testing of software, including detailed program specifications, dataset

descriptions, internal controls, security specifications, and procedures for all tests, as well as data reduction and evaluation criteria. Results of the test should be well documented and reflect any corrective actions taken as a result of the test. The decision to implement a system without exercising a well designed test plan presents serious risks to system integrity, reliability, and organizational operations.

g. Signed approvals should be obtained from the requestor, users, quality function, and IS management, prior to putting into production new or modified system software or applications software. This procedure establishes accountability for system results and provides an incentive to properly test and validate a system prior to implementation.

h. The contractor should be able to explain whether SDLC methodologies are employed for software acquisition, development, or modification and should also provide policies and procedures which govern SDLC implementation. The adequacy of SDLC implementation and compliance may be tested by reviewing at least one completed or in-process project processed under the SDLC methodology.

5-409 Computer Operations

Computer operations should provide reasonable assurance of the integrity of all activities impacting the physical operation of the computer and all peripheral components. Such activities may include system initiation, operator interaction, help desk assistance, print operations, and identification and correction of hardware and system software problems. As a minimum, controls should be established over:

- (1) system documentation
- (2) recording of transactions
- (3) hardware and software changes
- (4) maintenance of hardware and software
- (5) operational procedures
- (6) telecommunications

5-409.1 Decentralized versus Distributed Information Systems Processing

a. A decentralized Information Systems Processing (ISP) facility usually

maintains a home office (control hub) computer, but disperses many ISP activities throughout the company. Remote locations in a decentralized ISP facility possess independent processing capabilities through separate computing facilities. A variation of a decentralized ISP facility is a distributed ISP facility. The primary distinction between a decentralized and distributed ISP is networking and data communications. In a decentralized ISP system, each remote facility may periodically communicate with other sites. However, in a distributed ISP network, each remote facility, while possessing autonomous processing capability, represents an integral part of an overall data communication and information network. Data communications among the sites is an ongoing and essential element of the network rather than a periodic, ad hoc routine. A distributed data network is in fact, a tightly bound ISP facility.

b. Centralized and distributed ISP facilities are configured using central computers, local area networks (LANs), wide area networks (WANs) and stand-alone microcomputers. Decentralized ISPs and/or distributed ISPs, if applicable, are normally an element of the IS Department and are subject to the same audit procedures applied to a centralized data center's systems. The auditor should review policies, practices, and procedures addressing LAN and WAN operations, including data control, data security, and data communication. The auditor should also determine the distributed ISP system's configuration and the hardware and software in service. The transmission of information between distributed ISP nodes (or sites) presents a greater risk to data security and integrity than is experienced in a centralized data center due to the multiplicity of devices involved. Accordingly, the auditor should give particular attention to the review of distributed ISP database and data communication operations. In most instances, this will involve regional technical assistance.

5-409.2 System Documentation

a. Each major application system should be documented in a unique operations and maintenance manual. The

manual should be available for use in all software testing and accessible by all appropriate operations personnel. To help provide reasonable assurance of the proper processing of the relevant application system, the manual should include:

- (1) software function and hardware requirements
- (2) interactive system operation, database involvement
- (3) explanation of console messages, user screens queries, and related responses
- (4) proper identification of output file labels for removable media, such as magnetic tape
- (5) appropriate restart or notification procedures for error or failure conditions
- (6) checkpoint controls for proper run-to-run control of program operation
- (7) list of all reports generated by various run options for the system

b. The contractor should be asked to demonstrate that documentation on all system software is current and accessible only to appropriate system software personnel assigned to install and maintain the operating system and other system level software. Contractor data centers may be using on-line operations documentation in lieu of hard copy user manuals. Policies and procedures governing the creation and use of on-line operations documentation should be available.

5-409.3 Audit Trails

Manual and/or automated recording and reporting of systems processing activities are essential for safeguarding the integrity of the data processed. These reports, or system logs, provide audit trails for several functions, including: system security, data backup/recovery, and general problem resolution. Examples of where system log entries provide operational assistance include:

- (1) update and recovery of databases and data files
- (2) system accesses
- (3) computer performance
- (4) hardware/software failures
- (5) corrective actions

System logs are extremely important and should be implemented at any data

center, regardless of the size of the data center.

a. Access Logs may consist of records of physical access to data processing areas and equipment, or records identifying a system user's logical access to some application or communication network. The contractor should demonstrate that access logs are retained for a reasonable period and that they are periodically reviewed for compliance with established policies and procedures.

(1) Physical access logs are normally contractor maintained manual records which record visitor access to the data center or employee access at times other than normal working hours. Physical access logs can be automated depending on the type of access control system employed. For example, encoded identification badges could be electronically scanned and matched to a listing of authorized entrants. The authorized badge holder would be allowed entry and the badge number would be recorded.

(2) System access (logical) logs record, by User ID, all accesses to computer resources or to the data communications network. System logs help in the detection of unauthorized attempts to access computer resources and data.

b. Transaction Logs are the audit trail of all changes made to data elements contained in applications systems, including batch and interactive systems. These logs are normally automated and are critical to data center backup and recovery operations. Transaction logs should record:

- (1) all additions, deletions, and changes to the application data elements
- (2) the user making the changes
- (3) the day/time the transaction was made

The logs provide the primary source of data recovery if a system failure should occur. The contractor should be able to show that application system documentation provides for these audit trails and that the logs are fully operational. Documentation on system testing prior to implementation should contain information on the operational test of these logs for backup/recovery and identification of inadvertent transaction errors. The audi-

tor should request that data center personnel demonstrate the existence of these logs and provide documentation of their use during backup and recovery.

c. System Activity Logs record actual utilization of the hardware resources within the data center. These logs would normally identify:

- (1) the level of central processing unit (CPU) utilization
- (2) direct access storage device (DASD) activity and utilization
- (3) number of system users
- (4) job activity
- (5) other processing measurements needed to manage the performance and capacity of the hardware resources

The logs are a primary means of identifying processing problems created by inadequate or failing components. The contractor should be asked whether systems activity logs are being generated, since most operating systems provide an option to either not collect any data or to collect only a limited amount. The auditor should also verify the retention period for these logs. Normally, two to three months of systems activity data should be stored on DASD for on-line access, with an additional twelve to eighteen months of data stored on magnetic tape.

d. Maintenance Logs record all scheduled/preventive maintenance (PM) and corrective/remedial maintenance (RM) performed on the hardware components installed in the data center. PM provides reasonable assurance that required checks and procedures designed to minimize hardware failures are accomplished. RM is performed when hardware failures occur. RM logs are helpful in resolving recurring problems and identifying components requiring replacements. The auditor should determine whether the contractor maintains the PM and RM logs on a timely basis. The logs may be manually maintained or automated. The PM log should reflect the hardware manufacturer's basic requirements for periodic maintenance.

e. Problem Logs are maintained by the data center to identify system and application problems and to track the problems until corrected. The logs may be manually maintained or automated. The

contractor should be able to show that the log is in use and that all recorded problems have been acted upon. At many contractors, problem logs are the responsibility of the Help Desk function. Information systems (IS) problems or questions are directed to the Help Desk from throughout the organization. Help Desk personnel are responsible for logging the call, identifying the problem, resolving the problem, and documenting the series of events. The Help Desk may transfer the issue to another resolution source. The functions of the Help Desk should be documented in a standard procedure approved by IS management and distributed to all IS users.

f. Software Change Logs provide a record of all installations of system level software and applicable changes. They are an important part of change management and should be well documented in the policies and procedures governing change control. The changes may be vendor supplied or in-house changes required to customize the software to the contractor's special needs. The types of software involved would be operating systems, utilities, compilers, database management systems (DBMS), and other non-application software products. The logs may be manual or automated. The auditor should determine whether this type record is maintained, and that it:

- (1) contains all changes made to non-application software
- (2) is accurate
- (3) is current

There should be few in-house changes to operating system, utility, and computer software. The auditor should obtain copies of the contractor's work orders to the systems software developers to incorporate in-house changes in the next release of the system software.

5-409.4 Maintenance

a. Most computer hardware has the capability to detect and record hardware failures, although some systems are not designed to take advantage of available controls. Failure to utilize available hardware controls could result in significant processing errors. A number of undetected minor errors can have a cumulative

effect that could result in a major system or subsystem failure.

b. Active preventive maintenance (PM) and remedial maintenance (RM) programs are necessary to keep data center equipment operational. The data center should maintain a current schedule of all PM to be performed as required by the equipment manufacturer and should ensure that the PM is completed as scheduled. Contracts should be negotiated with equipment manufacturers or related equipment maintenance providers to provide timely RM in the event of hardware failure. For example, response time for making repair to hardware components that are critical to the continuity of operations, should, on average, approximate no more than four hours.

c. The auditor should determine whether the contractor has installed all vendor supplied failure detection software and that the output is monitored on a routine basis by operations personnel. The auditor should review the PM schedules and obtain contractor verification that PM has been performed as scheduled. The contracts for RM should be reviewed on a selective basis to ensure that maintenance responses are appropriate for critical hardware components.

5-409.5 Telecommunications

a. Over the years, contractors have steadily migrated from the traditional batch processing environment to an on-line access and processing environment. Although batch processing remains a important element of most data center activity, an ever greater number of jobs are being submitted through on-line access procedures. The current environment also supports significant database activity as a replacement to storage and retrieval of data from conventional sequential type data files. Database activity includes centralized database operations having many users accessing the same centralized database. It also may include distributed operations where users are accessing only their portion of the entire database which may reside at the mainframe data center or at a local node on the network.

b. The on-line or distributed users may access mainframe and peripheral hard-

were located in the data center through the contractor's or a commercially available telecommunication network. The telecommunications network may be a direct connection between the users and the data center or through other communication circuits, including land-lines, microwave transmitters, or dial-up connections. In general, telecommunications circuits are susceptible to access by unauthorized users; consequently, the effectiveness of the contractor's controls and management of the network should be closely scrutinized.

c. The contractor should be asked to demonstrate that a network management or other designated group has the responsibility to manage and control telecommunications resources. Standards for operation of the network should be published and distributed to all designated network users. The auditor should verify with network management personnel that all sensitive data in the network have been identified and that adequate precautions have been implemented to protect this data. The network hardware and software should be secured to minimize the possibility of unauthorized access to the telecommunication network. See Chapter 5-410 for additional information on reviewing the physical and logical security requirements for protection of hardware, software, and data.

5-409.6 Uninterruptible Power Supply (UPS)

Larger contractor data centers will have UPS units installed to furnish auxiliary electrical power in the event the normal power supply is disrupted. UPS configurations can vary between a simple battery backup to facilitate orderly power down of the system, to elaborate battery and motor-generator units which provide sufficient electrical power for the system to continue full operation. The contractor should have documentation regarding UPS operation and should demonstrate that the UPS is tested on a periodic basis.

5-410 Security

a. Information is one of the most valuable resources an organization possesses. Access to the computing resources

which process this information should be limited to users having a documented and authorized need for such access. Layers of physical and logical access controls should be provided to protect the organization's computing resources against damage, loss, or unauthorized use or modification.

b. Responsibility for assuring both the logical and physical security of the IS Department assets and processed data should be assigned to a security administration function which reports to senior management. The security administrator designee should have no conflicting job responsibilities or other incompatible duties assigned which would reduce the effectiveness of the position. For example, he or she should not perform systems or applications programming functions, operate the mainframe, or perform data entry duties. Where Security Administration is a part-time function, those duties should be performed under an exclusive User ID and all activities under this User ID should be logged and regularly reviewed by an appropriate person in the IS Department. The auditor should determine whether the security administrator position has been established, is currently filled, and that effective controls are in operation.

5-410.1 Physical Security

a. Physical access controls help protect computer center resources from unauthorized modification, theft, and/or destruction. Data centers should employ these controls to limit physical access to computing resources to only individuals who have been authorized to have such access. The auditor should request a demonstration by the contractor of all physical controls to verify that established policies and procedures have been effected.

b. Facility Security - Physical access to computer resources should be restricted to personnel having an authorized need for the access. Access control can be obtained by minimizing the number of entrances and exits at the site and by installing security devices requiring keys, badges, cipher codes, or other means to impede and control entry into the installation. Personnel access devices such as

badges, cipher lock codes, and keys should be changed or re-coded periodically, especially when employees who have had access to the computer center are terminated. Positioning the computer center in a relatively inaccessible area helps provide physical security. External identification of the facility should be limited to avoid bringing unwanted attention to the data processing department. IS personnel should not be authorized access to all areas of the data center. For example, computer operators should be restricted from data entry areas and systems programmers should be restricted from accessing the operations area. The auditor should verify that physical security has been provided for all computing resources including CPUs, peripherals, and telecommunications hardware.

c. Personnel Authorization - A current list of personnel authorized physical access to the installation should be maintained by the security administrator. Procedures should require the notification of the IS Department when an employee is no longer authorized access to the computer facility or other related resources. These procedures should also require that authorized visitors to the computer facility be escorted while in the restricted areas. The auditor should verify that a current list of personnel authorized entry into the data center is available. Also, a list of recently terminated or transferred employees could be obtained and compared with the latest authorization list to ascertain the timeliness of the data center access revocation procedure.

d. Inventory - A current inventory of IS Department computer hardware and software should be maintained outside the facility. The inventory could help facilitate the replacement of computer processing equipment following a disaster in which the data center was damaged or destroyed.

e. Alternate Storage Facilities - Offsite storage facilities should be used to store backup copies of critical data and program files. The contractor should ensure that procedures are in effect for the identification of critical data, system, and application files, and that there is a requirement for the routine backup and

transportation of these files to an offsite storage facility.

f. Environmental Protection - In addition to the usual fire and safety precautions normally installed to protect computer hardware facilities, other special equipment, devices, or methods may be employed to further help protect sensitive computer hardware. For example, fire suppression devices which use dry chemicals or gas, such as Halon, may be installed. The auditor should obtain a description of the environmental safeguards available at the site, and review the applicable policies and procedures in effect to monitor their operation.

g. Monitoring - In addition to controlling physical access to the computer facility and computing resources, continuous monitoring of personnel accessing the facility and resources should be effected. A log of all visitors to the data center should be required. Contractors may have automated security systems which require the use of a magnetically encoded badges to unlock the door and automatically log personnel entries and exits to the facility.

5-410.2 Logical Security

Logical controls are encoded or embedded into systems and application software with the objective of restricting or permitting access only to users who have been properly authorized such access. Examples of logical controls are User IDs, and uniquely created systems passwords.

a. Systems Software - System logical security is accomplished through the use of the security features of the operating system or through the use of commercially acquired security software such as ACF2, TOP SECRET, or RACF. In smaller data centers, the operating system security features may be the only software security package in service. Access to the computer system should be controlled through the assignment of unique user identification codes by the security administrator. The effectiveness of the policies and procedures which address the assignment of User IDs should be reviewed. User IDs should not be assigned by the security administrator unless specifically authorized by the ap-

appropriate management. Systems users should be required to periodically change their passwords. Procedures should require that employees who are terminated for any reason, have their access to system resources immediately revoked. All User IDs should be recertified on a periodic basis and system access revoked for current employees whose job duties no longer require access to system resources. The auditor should review IS policies and procedures to determine whether logical security options are identified and in use. The auditor should verify that:

- (1) system access cannot be effected without a valid User ID and password
- (2) password input is masked
- (3) passwords contain at least six characters
- (4) passwords are changed periodically

b. Application Software - User access should be restricted to those applications required to accomplish assigned duties. Application restriction is effected through operating system security or commercial security packages. Commercial security software normally invokes automated rules which restrict system users' access to certain applications or database elements. These rules are usually established for certain classes of users. For example, personnel involved in material inventory would not be permitted access to financial data or programs used by payroll personnel, and vice versa. Security system rules may be further profiled to restrict access to certain users within a class. For example, a payroll clerk may not have the same user rights as the payroll supervisor. Moreover, read only, write only, and read/write authorizations over selected datasets are possible.

c. The auditor should coordinate regional technical assistance, as necessary, to verify that contractor acquired security software (ACF2, RACF, etc.) have been placed in operation and that appropriate security rules have been invoked to protect all systems/application access/software processed by the data center. Contractors have been found to install expensive logical security packages and then not use the full security capabilities of the system.

The overall security administration function should be reviewed for adequacy, especially at the user level where access authorization for the various application is usually effected. Where data base management systems are used, a data base administrator may be the authorizing agent for assigning access levels to users. The auditor should verify that security personnel who authorize/assign user access to systems, promptly revoke access when the user transfers to a function not needing the level of access authorized or is terminated.

d. Dial-Up Security - Computer systems having communications capabilities can be accessed over common communication lines. This means that the physical security that protected the computer may no longer be effective. Where the computer can be accessed through a dial-up network (the CPU has a phone number), any telephone can theoretically access the system. Once the computer is accessed from a remote location, logical security should prevent unauthorized entry. Several dial-up security techniques are used. Some dial-up security systems call a subscriber back at a predetermined number, other techniques involve synchronous and/or encrypted methodologies. The auditor should review the contractor's procedures involving data center dial-up activity and determine whether dial-up is properly controlled and monitored.

e. All system access attempts should be logged by the security software in operation; i.e., commercial security software or the operating system security software. This access logging information should be used to generate violation and security activity reports which should be monitored by the contractor to identify and resolve incidents involving unauthorized activity. The auditor should review the contractor's procedures for monitoring and resolving reports of security violations and associated activities and verify that these procedures are being followed. The auditor should also determine that the contractor's records of security violations are protected from inadvertent or intentional destruction. Repeated failed access attempts should be identified, re-

ported by the security system, and investigated by security personnel to determine the cause. This could be an indication that someone is randomly entering User IDs or passwords in attempting to gain unauthorized access to the system. The auditor should verify that User IDs that have not had activity for a reasonable period are deleted and determine whether terminated employee User IDs are revoked in a timely manner.

f. The contractor should provide employee training in logical access to computer resources. Unambiguous logical access procedures should be developed and provided to all employees accessing computer resources. The auditor should verify that the contractor is providing adequate staff training in this area.

g. Modern data centers often consist of several computer platforms (mainframes, local area networks, workstations, and individual PCs) and a variety of security software and application software. Generally, each software system has its own inherent security that must be considered in order to assess the overall security level in effect within the data center. Users can pass through several computer platforms and security software systems, and possibly access more than one data center, during a single session. It is therefore important for the auditor to determine that security controls are in place over all operating environments. Logical security systems (RACF, ACF2, etc.) should be in use for the mainframe and its resources. The security software should also protect the communications network (Netware). Security software should also be in use for interactive processing systems (CICS) and for database management systems (e.g., IMS, DB2). The auditor should identify the security systems in use at a data center, and the interaction among them, in order to verify that the contractor's data is being adequately protected from unauthorized access.

h. Application systems that are developed by the contractor or acquired commercially should follow a sequence of migrations as part of the implementation strategy. Data are first placed in a test environment. When testing is completed, the data are migrated to an accep-

tance/training environment, and finally, to a production environment. Generally, there will be a separate set of users and data for each environment. For example, in a database management systems (DBMS) environment such as DB2 or IMS, there would normally be separate operating copies of the software and data for each environment. The security should be more restrictive as the application migrates from the testing to the production environments. The auditor should determine whether the contractor has a software migration strategy which is being used, and that security access levels for each environment have been granted based on a demonstrated need.

5-411 Contingency Planning

Contractor policies and procedures should contain provisions for the continuation of EDP operations in the event of a disaster or failure which renders the EDP center inoperable. Contingency (disaster recovery) plans should be in place for the back-up and recovery of IS department services in the event of unanticipated interruptions to EDP operations. Contingency planning can be critical to the resumption of operations in the event of a major hardware or software failure for whatever reason. The plan should include:

- (1) identification of critical processes and data
- (2) provision for an alternate processing site
- (3) offsite storage of critical application programs and data
- (4) provisions for periodic testing of the plan

The auditor should review the contractor's EDP Disaster Recovery Plan to determine whether the plan reasonably addresses the actions to be taken in the event of a disaster and identifies personnel and their responsibilities in restoring data processing operations.

5-411.1 Critical Processes and Data

Contingency planning should provide for priorities in the establishment of the processing of specific critical or sensitive application programs. Critical data processing applications, operating systems,

5-411.1

and data files need to be identified and placed on a list of priorities for the establishment of services based on the nature and extent of a likely disaster. Priority on the list should be minimally based on a reasonable expectation of elapsed time before normal data processing operations are restored, and the potential loss to the organization if the processing of the application is not restored in a timely manner.

5-411.2 Alternate Processing Site

Contingency plans should contain provisions for an alternate processing site and appropriate data processing hardware needed to restore data processing operations after a disaster occurs. The contractor should have a written agreement or contract with the alternate site specifying the procedures each party will follow in the event of a disaster. Criteria for selection of the alternate site should include:

- (1) compatible computer hardware
- (2) sufficient time and processing capacity
- (3) periodic tests of alternate site computer hardware

The auditor should review the contractor's alternate site plans to determine whether they are current and address equipment, capacity, and timing requirements. The auditor should review contract provisions the contractor has made with alternate-site vendors and equipment providers to determine whether an adequate site and essential computing

hardware will be operational within the time limits prescribed in the contingency plan.

5-411.3 Offsite Storage

Normal systems operations should include routine back-up of data files, application programs, and system software. The auditor should review the contractor's procedures for storage of these files at a location which should not be affected in the event of computer center disruption and would be available for use in data processing recovery at the alternate site. The auditor should also review the contractor's procedures and actual practices for storing files offsite.

5-411.4 Test Plan

Contingency plans should be tested periodically to determine their effectiveness. Results of the tests should be documented. Deficiencies noted during the test should be resolved in a timely manner. The auditor should review the results of the test plan to determine whether all elements were tested and that deficiencies noted during the test were satisfactorily resolved.

5-412 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-500 Section 5 — Review of Contractor Budgets**5-501 Introduction**

Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

5-502 Budgeting Concepts

a. Plans and budgets are key managerial tools used to plan and control operations. A plan or budget identifies expected revenues to be received and resources to be expended in achieving an organization's goals during a specified future period. Plans and budgets provide a control to measure performance. In general, a plan or a budget:

- (1) is stated in monetary terms
- (2) covers a specific period of time (generally one year for the master budget and several years for long-range plans)
- (3) implies commitment (i.e., managers agree to accept responsibility for attaining budgeted objectives), and serves as a motivational tool for individuals to strive to achieve stated goals
- (4) is reviewed and approved by a management level higher than the unit preparing the budget
- (5) can only be changed under specified conditions
- (6) is compared to actual performance, with variances being analyzed and explained

b. Planning and budgetary systems vary among companies according to organizational size and structure, type of product or service, accounting system, personal preferences of corporate officials, and other influences. Planning and budgeting systems can be manual or automated. However, in larger companies EDP systems are used more extensively to collect and analyze data and prepare plans and budgets. Plans and budgets may be prepared on either a functional or organizational basis. Generally, a contractor's planning and budgetary system should have:

- (1) A functional organization with defined organizational responsibilities, a written description of the work flow in the planning and budgeting process, and policies and procedures for effectively controlling the process.
- (2) A strategic and long-range planning process to develop the long-term goals and objectives critical to the operation of the company.
- (3) Effective techniques for preparing budgets.
- (4) Procedures for comparing actual performance to the budget, identifying and analyzing variances as work is accomplished, studying the impact on remaining effort, and initiating necessary corrective action. Procedures should provide for promptly revising estimates to complete and notifying the government of projected overruns or underruns.
- (5) A replanning capability to react to significant changes in assumptions, such as a major fluctuation in the forecast volume.

5-502.1 Access to Budgets

a. Plans, budgets, and forecasts meet the definitions of "records" and "data" contained in FAR 52.215-2, "Audit Negotiation," and 52.214-26, "Audit Sealed Bidding." The applicability of these FAR sections are agreed to by contractors when submitting price proposals and executing contracts with DoD components. These contract clauses give the auditor the right of access to a contractor's planning and budgetary data after contract award. (Also see 1-504, Access to Contractor Records.)

b. Recognizing that planning and budgetary data is generally considered proprietary and sensitive by contractors, sound judgment must be exercised in determining which records and data are needed. (For example, data such as pricing formulas for commercial products may not concern the government.) In requesting budgetary data, informal arrangements acceptable to the auditor

concerning the timing and frequency of access may be established, but see 1-504.1f.

c. Planning and budgetary information generally required during the performance of the internal control audit includes:

- (1) identification of all budget documents and reports;
- (2) policies and procedures concerning the preparation, authorization, and approval of budgets; and
- (3) all current operating plans, budgets and performance and variance analysis reports for use in testing system effectiveness.

d. When the contractor denies access to such records, follow the procedures outlined in 1-504.

5-503 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy that contractor planning and budgetary system internal control reviews be performed at least every three years at large business contractors which in their preceding fiscal year received DoD prime contracts or subcontracts of at least \$50 million which required certified cost or pricing data. These reviews are oftentimes conducted in conjunction with the estimating system review (5-1207.3). These reviews may be waived or modified by the written approval of the regional audit manager if past experience and a current assessment (see 3-300) indicate low risk. This determination of low risk must be fully documented. If the audit risk is considered to be high, budgetary system reviews should be performed more frequently. These reviews should also be considered at smaller contractor locations where there are indications of significant budgetary system problems.

c. If the audit risk assessment indicates that only certain parts of a contractor's budgetary system are subject to high risk, only the high risk areas would require a complete review. Areas of little or no risk need not be reviewed so long as the low

risk determination is adequately documented.

d. FAOs with audit cognizance over corporate and/or group offices allocating substantial costs to other segments for ultimate allocation to government contracts are responsible for performing budget reviews at these offices and providing the results of the review to the segment auditors. Auditors at segments receiving these allocations are to request such reviews as needed.

5-504 Audit Objectives

a. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The primary audit objective in reviewing contractor budgetary systems and data is to establish that a sound budgetary system is operating for company planning and cost control purposes. A secondary objective is to obtain a comprehensive overview of the contractor's financial planning and control procedures and practices. Related objectives are to determine whether:

- (1) Costs estimated and/or incurred for government work are developed, recorded, and controlled on a basis consistent with management's latest, "most probable" plans.
- (2) Direct and indirect efforts for government contracts are estimated and performed efficiently and economically.
- (3) Significant changes in plans and circumstances are reflected promptly through controlled and documented revisions to budgets and estimates to complete.
- (4) Reports to the government on major contracts and weapon systems are consistent with the contractor's latest budgetary data. These latter objectives should be considered for in-depth coverage during reviews of forward pricing proposals and indirect rate forecasts (Chapter 9), reviews of contractor compliance with Cost/Schedule Control Systems Criteria (11-200), and postaward reviews (14-100).

5-505 Scope of Audit

While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105. In general, the audit scope should include:

- (a) obtaining an understanding of the contractor's planning and budgeting system and related internal control structure;
- (b) documenting the understanding of the planning and budgeting system internal control structure;
- (c) testing the operational effectiveness of planning and budgeting system internal controls;
- (d) assessing control risk as a basis to identify factors relevant to the design of substantive tests; and
- (e) reporting on the understanding of the internal control structure, assessment of control risk, and adequacy of the system for government contracts.

5-506 Functional Organization

a. The planning and budgeting function may be organized differently by individual contractors because of differences in their products or services, industry practices, size and type of organization, degree of departmentalization, management attitudes, personnel capabilities, and other factors. Responsibility for developing plans and budgets may be centralized in a planning or budgeting group or delegated to the various participating departments. However, the planning and budgeting function should be soundly organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level.

b. The contractor should establish clear responsibility for preparation, review, and approval of plans and budgets, to include establishing and maintaining:

- (1) written documentation of current organizational responsibilities and the duties of budgeting personnel

- (2) a system description of the work flow in the budgeting process from the development of strategic objectives to budget execution and revision
- (3) written policies and procedures

5-506.1 Organization

Evaluation of a contractor's planning and budgeting organization requires analysis of the relationship of the organizational segments participating in the planning and budgeting process. When evaluating the organization of the contractor's planning and budgeting process, the auditor should consider whether:

- (1) Preparation of required plans and budgets is effectively controlled either on a centralized or decentralized basis.
- (2) Lines of authority, duties and responsibilities are clearly defined, including responsibilities for preparing, reviewing, and approving plans and budgets.
- (3) The planning and budgeting process is properly coordinated among segments of the organization responsible for developing related parts of plans and budgets.
- (4) The department responsible for overall compilation of the plans and budgets has authority to review and question the reasonableness or accuracy of feeder information received from other departments.

5-506.2 System Description

a. The contractor should maintain a written description of the work flow in the planning and budgeting process from the development of strategic objectives to budget execution and revision. This description should contain sufficient detail to allow the auditor to obtain a thorough understanding of how the planning and budgeting system operates. The description should include references to written policies, procedures, and operations manuals. Information should be provided for each process or function within the system as well as existing internal controls.

¶5-506.2b.

b. The contractor's system description should identify the duties of personnel responsible for preparing, reviewing, and approving plans and budgets, and the various functions contributing to the planning and budgeting process.

5-506.3 Policies and Procedures

a. Written policies and procedures help ensure that:

- (1) delegated duties and responsibilities are formally documented and communicated to employees
- (2) specific planning and budgeting controls operate consistently from period to period
- (3) established plans and budgets are consistent with management's goals and objectives

A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial government business.

b. Planning and budgeting policies and procedures represent the means by which goals and objectives established by management are translated into detailed guidance and direction to personnel engaged in the planning and budgeting process. Policies and procedures should cover all aspects of the planning and budgeting system, be approved by an appropriate level of management, communicated to appropriate personnel, and periodically reviewed to ensure that they are consistent with management's intentions. When evaluating the contractor's policies and procedures, the auditor should consider whether they:

- (1) Address all major duties and responsibilities in the planning and budgeting system. The auditor should be alert for aspects of the planning and budgeting process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these instances, the auditor should consider the under-

lying cause for these inconsistencies (i.e., failure to adequately communicate changes in established policies and procedures).

- (2) Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to following established policies and procedures. The auditor should carefully assess the level of management approval to determine if it is appropriate given the nature of the duties and responsibilities being assigned. While not inherently indicative of poor policies and procedures, failure to involve an appropriate level of management in the approval process can result in a perceived lack of importance and ultimately a lack of compliance.
- (3) Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures but providing the necessary training to ensure that they understand how to execute them.
- (4) Have been subject to periodic reviews to ensure that they are consistent with current management intentions and actual planning and budgeting practices. Failure to keep established policies and procedures current is indicative of a poor internal control environment and typically leads to ineffective internal controls over the planning and budgeting process. For this reason, management should have a systematic process in place to periodically review and update the planning and budgeting policies and procedures, including applicable EDP policies and procedures. The required frequency and depth of these reviews depends on the nature of the contractor's business. If the contractor is undergoing significant organizational changes or major restructuring of its business operations, the planning and bud-

getting system should be closely monitored to ensure that it continues to produce plans and budgets which are consistent with management's goals and objectives.

5-507 Strategic or Long-range Planning

a. Strategic or long-range planning refers to the process of developing general goals and objectives for a business unit, and the broad strategies to be used to attain them. It provides general direction covering a three- to ten-year period and forms the basis from which a more detailed plan, encompassing a shorter period and generally known as the master budget, is developed.

b. The strategic plan is generally a narrative document. It affects the physical, financial, and organizational structure in which operations are carried out and addresses the direction of the company regarding new markets, market share, profit objectives, sources of new capital, and the acquisition or elimination of segments, facilities, or product lines. Based on these considerations, a plan for future operations which provides for alternative courses of action under various conditions that may arise is developed. Contractors should review these plans periodically and revise them when new information yields different conclusions.

c. Long-range plans may include forecasted financial statements, cash flow projections, and various other data. This data is sometimes in graphic form and similar to that contained in short-range budgets. A typical long-range plan contains information on predicted sales and profit trends by major product line, backlog, potential awards, new product lines, diversification plans, planned plant facilities, staffing requirements, and independent research and development plans.

d. Strategic or long-range plans of major defense contractors generally include information which significantly affects proposals and contracts for long-term government work. They may reflect contemplated substantial increases or decreases in future work load affecting plant population (payroll costs), plant

expansion (depreciation or lease costs), physical moves (relocation costs), idle or excess facilities, and bases for determining overhead rates. In addition, they may reflect possible future financial problems in periods beyond those reflected in master budgets.

e. An adequate strategic and long-range planning process will ensure that important information related to the physical, financial, and organizational structure of the organization are available for the development of effective budgets. The development of a strategic or long-range plan is the first step towards identifying and documenting how management intends to accomplish the goals and objectives of the organization. Strategic and long-range plans, while broad in nature, set the foundation for more detailed planning and budgeting decisions. When evaluating the effectiveness of the contractor's strategic and long-range planning process, the auditor should consider whether these plans:

- (1) cover all areas which impact the overall operation of the company
- (2) are documented in sufficient detail to enable assessment of the reasonableness of the underlying assumptions
- (3) are communicated to personnel responsible for preparing long-range plans and related budgets

5-507.1 Scope of Planning Activities

Strategic and long-range plans should cover all areas which have an impact on government contract pricing, costing, billing, or related reporting requirements. These areas may include such things as projected business volume, planned reorganizations, anticipated plant expansions/retirements, etc. Contractor strategic and long-range plans should cover, at a minimum, the length of current and forecasted government contract activity to ensure that sufficient information exists to prepare related contract reporting requirements (i.e., estimates at completion) and proposals for anticipated contract awards.

5-507.2 Documentation of Plans

Strategic and long-range plans should contain sufficient documentation for the

auditor to assess the reasonableness of underlying assumptions and to facilitate the communication of key information to personnel responsible for preparing related budgets. For example, contractor plans regarding future sales volume should contain sufficient detail and documentation to assess the reasonableness of the assumptions used to arrive at firm and projected government and commercial business. While contractors are not expected to develop infallible estimates, they should be able to present evidence in support of the reasonableness of such estimates in cases where those estimates will impact the pricing, costing, billing, or related reporting on government contracts.

5-507.3 Communication of Planning Information

Key financial and related information contained in the strategic and long-range plans should be communicated to personnel responsible for preparing related budgets. While most contractors will not routinely release their strategic or long-range plans to the general work force, they should have in place a process for releasing key information to those individuals who are responsible for preparing budgets. This communication is essential to ensuring that budgeted amounts accurately reflect management's current business plans and forecasts.

5-508 Preparation of Budgets

Budgets are detailed and comprehensive plans for the immediate budget period, normally covering one year. They are developed through the coordinated planning of all functions and activities within an organization and consist of two major elements, the operating budget and the financial budget. The entire master budget is usually distributed only to executives and top-level managers. Lower level managers usually receive only those sections for which they are responsible.

a. Operating budget. An operating budget is a forecasted net income statement consisting of several sub-budgets (e.g. sales, cost of goods sold, direct and indirect expenses) and summarizing the

individual budgets of each department or function within an organization.

(1) Sales budget. The sales budget is the starting point for the entire master budget. From the sales budget, resource requirements are developed for work already under contract, new work expected during the budget period, administrative functions, and independent research and development efforts. Required resources include total staffing needs, space, capital expenditures, utility requirements, direct and indirect material needs, employee fringe benefit costs, and others.

(2) Program or production budgets. A program or production budget is part of the operating budget. It is a summary type document used to project direct and indirect resource requirements needed to meet forecasted sales volume. It typically includes a series of sub-budgets. These sub-budgets are generally for direct labor, direct material, other direct costs, and overhead. It may also include quantity and scheduling information on parts, major assemblies, and deliverable hardware. Once quantity requirements are defined, each of the various sub-budgets is developed based upon those requirements. Program budgets are generally prepared for each accounting period by contract, program, or product line. The level of detail in a program budget varies, based on program size and contractual requirements. The estimated effort in the program budget should reconcile to similar data in the operating budget, and the overall management controls imposed by the operating budget also apply to individual program or contract costs. Automated systems used in the process should include controls which identify and report reconciliation errors. Some small tolerances may be built into the system; for example, insignificant dollar amounts or percentages. However, these should be clearly identified with controls in place to prevent changes without proper authorization.

(3) Staffing budget. The staffing budget shows staffing requirements for both direct and indirect employees.

b. Financial budget. The financial budget is a forecasted balance sheet consisting of sub-budgets, typically the capital expenditure plan and cash flow projec-

tions. A capital budget shows total planned capital asset acquisitions, each designed to contribute to the productive facilities required to support planned volume. It formalizes capital expenditure funding and is typically approved by a special appropriations committee. (See 14-600.)

c. Motivational budgeting. Some companies use a budgeting philosophy known as motivational budgeting whereby management establishes extremely tight goals and targets as a means of motivating better performance and cost reductions. When such techniques are used, they are usually reflected in the budgets of lower level managers from whom resources expected to be available are held back. Sometimes these resources are ultimately distributed. On the other hand, top management may never intend to allocate these resources to the operating managers but instead use them as a control device against which to offset unfavorable variances. By using this technique, top management establishes different goals or levels of expected performance for selected segments of its organization. Accordingly, the auditor must determine that staffing level forecasts and supporting expense projections in operating level budgets reconcile with the higher level master budget. If significant differences are found, the auditor should obtain an explanation, and assess the reasonableness of any management reserves.

d. An adequate budgeting process will ensure that budgeted amounts reflect the reasonable cost of work to be performed. The preparation of effective budgets is an essential part of any contractor cost control effort. It not only serves as a baseline for evaluating performance but also helps identify areas requiring special attention. When evaluating the effectiveness of the contractor's budget preparation process, the auditor should consider whether controls are in place to ensure that budgets are:

- (1) prepared for appropriate time periods and in all areas which impact government contracts
- (2) prepared in a timely manner

(3) consistent with strategic and long-range plans

(4) aggressive but attainable

(5) approved by an appropriate level of management

(6) communicated to appropriate individuals within the organization

5-508.1 Scope of Budgets

Budgets should be prepared for all major aspects of the contractor's operations which have an impact on government contracts. The auditor should be alert for areas of the contractor's operations in which budgets are not prepared or prepared in insufficient detail to serve as a baseline for controlling costs. In addition, budgets should cover a sufficient period of time to allow for the effective management of the operations being budgeted. For example, budgets for overhead or general and administrative expenses typically cover a single operating period while program budgets or capital expenditure budgets may cover several years. The auditor must exercise considerable care in evaluating the scope of the contractor's budgeting activities and the effect that it has on other contract audit effort, particularly contract pricing.

5-508.2 Timeliness of Budgets

Budgets should be prepared and finalized early enough in the budget cycle to maximize the amount of time individual managers have to meet the budget objectives. Failure to develop budgets early in the budget cycle can result in ineffective control over cost incurred prior to implementation of the budget. This can often create additional pressure for managers to redirect costs in an effort to meet the budget objectives. The auditor should consider whether or not the contractor establishes a formal timetable for the budget preparation process and controls the process to identified milestones.

5-508.3 Consistency with Strategic and Long-Range Plans

Budgeted amounts should reflect the goals and objectives contained in the contractor's strategic and long-range

plans. Since a major purpose of budgets is to help achieve the strategic and long-range goals of the company, it is important that those objectives be considered in the budget preparation process. For example, the auditor should consider whether:

- (1) strategic and long-range planning information is communicated to budgeting personnel at the beginning of the budget preparation process
- (2) budget objective guidance is prepared and distributed by individuals who are familiar with strategic and long-range goals
- (3) budgets are reviewed for consistency with strategic and long-range objectives prior to final approval

5-508.4 Development of Budget Amounts

Budgets that are not sufficiently aggressive may not maximize the contractor's opportunity to achieve strategic or long-range objectives. Conversely, budgets that are too aggressive increase the risk that individual managers will misallocate resources in an attempt to meet budgets, or not attempt to meet budgets they perceive as unattainable. For example, the auditor should consider whether:

- (1) guidelines are established for the use of scientific/technical studies (e.g., work measurement standards), historical performance, cost/benefit analysis, accepted economic indices, and/or other objective techniques;
- (2) budgets are coordinated with appropriate personnel, particularly individual managers responsible for performing within budgets, by soliciting their input, and obtaining their concurrence before finalizing budgets; and
- (3) supporting data and rationale is required to be documented for use in the preparation of future budgets.

5-508.5 Management Approval

Final budgets should be reviewed and approved by an appropriate level of management. Formal requirements for management approval help ensure that man-

agement is aware of specific budgetary objectives, and evidence of management approval increases the authority of budgets by demonstrating management support for budgetary objectives. For example, the auditor should consider whether:

- (1) budgetary documents require management approval
- (2) the level of management approval for different budgets has been identified
- (3) managers are allowed sufficient time to effectively review budgets prior to approval
- (4) documentation standards exist for management review, adjustments, and approval to ensure that individual managers are aware of management's support for budget objectives

5-508.6 Communication of Budget Information

Budget information should be distributed to individual managers responsible for meeting budgetary objectives and to personnel responsible for monitoring budget performance. For budgets to be effective, these individuals must have the specific information they need to perform their duties. For example, the auditor should consider whether budget formats are formalized to ensure that relevant information is distributed to the individual managers and monitoring personnel; and, a distribution list is maintained showing the appropriate budget formats and/or relevant budget information to be distributed to individual managers and monitoring personnel.

5-509 Performance Measurement

Actual performance should be periodically compared to budgeted amounts to allow for the prompt identification of variances and implementation of necessary corrective actions. Budgets are designed to serve as a baseline for comparing actual performance with established strategic or long-range goals. To effectively accomplish this, contractors should have a formal system for monitoring actual budget performance. In evaluating the effectiveness of the contractor's monitoring, the auditor should consider

whether actual performance is periodically compared to budgeted amounts and that variances are identified and reported; and, necessary corrective actions are identified and implemented in a timely manner.

5-509.1 Comparison of Actual and Budgeted Amounts

Periodic comparison of actual performance and budgeted amounts increases the likelihood that budgetary objectives will be met by providing individual managers with the opportunity to take corrective actions to control potentially significant variances. To accomplish this, the contractor should have a formal system which identifies:

- (1) variance analysis reporting thresholds or other criteria to define what management considers to be a reportable variance
- (2) variance computation guidelines to help identify potentially significant variances
- (3) standard variance report formats to facilitate monitoring of significant variances by providing consistency and comparability between reporting periods
- (4) formal variance analysis reporting periods
- (5) distribution of detailed variance analysis reports to individual managers subject to budgetary control
- (6) distribution of summary variance analysis reports to upper management so they can monitor budget performance in relation to strategic and long-range objectives to determine if revisions to strategic or long-range plans are needed

5-510 Budget Revisions

Budget revisions, when necessary, should be controlled to ensure that they are justified, documented, approved, and processed in a timely manner. While budget revisions are inevitable, contractors should have a formal system for submitting, reviewing and approving requests for such revisions. Failure to establish such a system can result in excessive or unnecessary budget revisions and undermine the integrity of the entire

budgeting process. In evaluating the effectiveness of the contractor's budget revision process, the auditor should consider whether procedures are in place to ensure that budget revisions are justified and necessary budget revisions are made in a timely manner.

5-510.1 Justification for Budget Revisions

Requests for budget revisions should be carefully screened to ensure that a valid reason exists for adjusting the budgeted amounts. Failure to meet budget objectives should not be considered a valid reason for making adjustments. The contractor should establish a formal decision making process to review, document, and approve all requests for budget revisions. This process should include:

- (1) a formal management policy on budget revisions to ensure that corrective actions or other measures are attempted before revising budgets
- (2) criteria for evaluating requested revisions to ensure approvals are consistent with management policy
- (3) thresholds established to minimize requests for immaterial revisions
- (4) provisions for upper management to initiate budget revisions based on changes in strategic or long-range plans
- (5) criteria for reviewing and approving requests for budget revisions that maintain the same level of control as those established for preparation of initial budgets

5-510.2 Timely Implementation of Budget Revisions

Timely review and approval of budget revisions increases the likelihood that revised budgetary objectives will be met by maintaining the integrity (reasonableness/attainability) of the budget and by providing individual managers as much time as possible to achieve the revised objectives. For example, the auditor should consider whether:

- (1) corrective actions are monitored to identify when budget revisions may be necessary
- (2) there is periodic communication between the budget department (or

- other organizational element responsible for reviewing and approving budget revisions) and individual managers to identify the need for budget revisions as soon as possible
- (3) standardized request formats and procedures are used to expedite processing of requests for budget revisions

5-511 Reporting Audit Results

a. The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

b. Conduct an exit conference in accordance with 4-304. Include the contrac-

tor's reactions in the working papers and the report.

c. If deficiencies have been disclosed and/or recommendations are presented in the report, schedule a follow-up review to be performed within a reasonable period of time.

d. If the contractor has contracts requiring an approved C/SC system, provide an assessment of whether any deficiencies are likely to have a material effect on the reliability of the contractor's C/SC system (10-408.b). The auditor should immediately evaluate the impact of deficiencies which may have a material effect on reports submitted for specific contracts requiring an approved C/SC system and provide the details in C/SC systems surveillance reports (11-209e).

5-600 Section 6 — Purchasing System Review**5-601 Introduction**

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal structure and assessing control risk.

b. This section presents guidance for reviewing a contractor's internal controls of both a manual and automated nature over purchasing and subcontracting. The guidelines relate to the assessment of control risk based on a review of the contractor's policies, procedures, and internal control structure. Guidance on reviews of other components affecting incurred material cost is in 5-700.

5-602 Background Information

a. The purchasing and subcontracting function includes make or buy decisions, the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administering of orders, and expediting delivery of materials.

b. Purchasing systems vary among companies according to organizational size and structure, EDP capabilities, accounting system, personal preferences of corporate officials, and other influences. In general, the critical control objectives a contractor's purchasing system should have include:

- (1) Internal audits or management reviews, training, and policies and procedures for the purchasing department to ensure the integrity of the purchasing system.
- (2) Policies and procedures to assure purchase orders and subcontracts contain all flow down clauses, including terms and conditions required by the prime contract, as well as any clauses needed to carry out the requirements of the prime contract.
- (3) An organizational and administrative structure that ensures effective and efficient procurement of required quality materials and parts

at the most economical cost from responsible/reliable sources.

- (4) Selection processes to ensure the most responsive and responsible sources for furnishing required quality parts and materials and to promote competitive sourcing among dependable suppliers so that purchases are reasonably priced and from sources that meet contractor quality requirements.
- (5) Price or cost analysis performed with every purchasing action.
- (6) Procedures to ensure that proper types of subcontracts are selected and that there are controls including oversight and surveillance of subcontracted effort.

5-603 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. The administrative contracting officer (ACO) is responsible for reviewing the contractor's purchasing systems. In accordance with FAR 44.3, a contractor purchasing system review (CPSR) shall generally be conducted at least every three years for each contractor whose sales to the Government, using other than sealed bid procedures, are expected to exceed \$10 million during the next 12 months. In accordance with DFAR 244.301, members of other organizations such as audit or program management activities should not conduct separate reviews for these contractors, but may participate in a review conducted for the ACO by the DLA CPSR team. These organizations may, if they suspect a problem, recommend that the ACO initiate a special review.

c. DCAA's audit objective is the adequacy of the internal controls over the system and the contractor's monitoring of compliance with its controls. The DLA CPSR team normally covers most DCAA concerns regarding internal controls. Therefore, it is extremely important that prior to commencing any review of the

contractor's purchasing system, the auditor coordinate with the contracting officer and the DLA CPSR team (see 5-1300 and FAR Part 44 for discussion of DCAA's participation on joint CPSR reviews). If a CPSR is planned, the DCAA auditor should be a member of the CPSR team and the scope of the review should be discussed. There should be mutual agreement in the planning stage on what additional audit steps will be necessary to address DCAA's concerns. During the CPSR, it is not the auditor's responsibility to review the quality of the CPSR team's work. However, the auditor should understand the scope of the work being performed in order to assess whether additional steps are required to satisfy DCAA's concerns. The auditor will make maximum use of the work performed and the conclusions reached during these reviews in establishing the extent of any separate coverage and audit tests to be undertaken in this area (see Appendix D-300).

d. If there is no CPSR scheduled in a reasonable time and the auditor feels the government is at risk, these concerns should be elevated to the regional office prior to any audit effort. Otherwise any DCAA audit effort should be deferred until the next scheduled CPSR.

e. If the audit risk is considered to be high, purchasing system reviews should be performed more frequently. These reviews should also be considered at smaller contractor locations, who are below the CPSR/DLA \$10 million requirement, where there are indications of significant purchasing system problems. Such reviews may be performed in conjunction with estimating system surveys (see 5-1200).

f. Once a comprehensive review of a contractor's entire purchasing system has been performed, it should serve as a baseline for establishing the scope of subsequent purchasing system reviews. Subsequent reviews would normally be limited to purchasing system changes and other areas identified as high risk.

5-604 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contrac-

tor's compliance with the purchasing system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The primary audit objective in reviewing a contractor's purchasing system is to obtain a sufficient understanding to plan related contract audit effort. This requires that the auditor assess the adequacy of the contractor's purchasing policies and procedures, whether they have been implemented, and if they are working effectively.

5-605 Audit Scope

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. The extent of audit effort should be influenced by (1) reviews by other agencies (CPSRs); (2) the types of government contracts and their materiality; (3) the adequacy of the contractor's policies, procedures, and internal structure on other major systems; (4) the results of prior reviews; (5) deficiencies noted in ongoing audits (audit leads); (6) the extent and results of contractor self assessment reviews; (7) the extent of automation; and (8) contract provisions. General information regarding these scope areas is provided in 3-104 and additional considerations specific to the purchasing system are discussed below. Working papers will include a risk assessment documenting the impact of the above eight areas on audit scope.

5-606 Compliance Reviews, Training, and Policies and Procedures

The contractor should have policies and procedures for monitoring its purchasing systems, training its employees, and ensuring the integrity of the purchasing system.

5-606.1 Compliance Reviews

Systems with weak or nonexistent internal control structures only increase the risk of cost mischarging or misallocation.

The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should conduct regular internal compliance reviews. These compliance reviews should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom, and timely follow-up action on deficiencies.

a. Types of Reviews. The contractor may perform internal compliance audits using auditors or nonauditors, rely on monitoring in the form of physical observation, rely on reviews of performance or exception reports, request external audits, or use a combination of techniques.

The contractor may have several functions performing the reviews. The contractor may also have various performance criteria and reporting requirements to upper management which relate to the timeliness and effectiveness of the purchasing function. For example, excessive number of days to process requisitions, work stoppages resulting from delays in receiving material, how many orders are issued per day per buyer, etc.

b. Adequacy of Procedures. Whatever the form of the reviews, there should be procedures which identify the intervals of performance of the reviews, the personnel responsible for performance of the review, the areas to be covered during the reviews, documentary evidence that the review has been performed, and the requirements for follow-up action. The procedures should address coverage of the following areas: review of the adequacy and consistency of application of the written procedures by buyers, EDP interface with the purchasing system, employee knowledge and compliance with these written procedures, and responsiveness to required corrective actions. Policies and procedures should assure that purchasing personnel are complying with applicable public laws and implementing government regulations, (e.g. Truth in Negotiations). (DFARS C-203.1(c)(1)(ii)).

c. Adequacy of Reviews. The adequacy of the reviews should be assessed in

accordance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing a level of competence, independence, and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, the adequacy of the contractor's ethics program, and untimely follow-up actions.

Policies and procedures should support a system that provides for tracking responses to and resolution of required corrective actions in a timely manner. The auditor should determine whether the corrective actions are (1) communicated to the management level responsible for action, (2) monitored for timely resolution, and (3) documented and verified.

5-606.2 Training

Training of Employees. A well trained staff results in current, accurate, effective, and efficient purchases. Contractor personnel need to be specially trained in Government purchasing regulations, contract clauses, and contractor procedures. Additionally, purchasing department personnel should have sufficient supplier and technical knowledge to make it unnecessary to depend wholly on engineers and other technicians to dictate the source of supply or price. Therefore, the contractor should have standards for the qualification, training, and experience of its purchasing personnel. (also refer to DFARS C-202.6)

a. Types of Training. The contractor may require that personnel responsible for various types of procurement have special qualifications prior to their being hired. The contractor may provide opportunities for personnel to take outside educational courses or provide internal courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures.

b. Adequacy of Training Procedures. Procedures should identify the minimum required course topics, the frequency of

the training, and the criteria for documentation of completion. If specific procedures are not available, the auditor should have the contractor identify its practice in the above areas for later verification with employees. The procedures should require the training program be updated to cover current government rules and regulations and adjusted to comply with revisions to the contractor's system. These areas may be covered under more than one training class and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. Training programs may include (1) an overview of the contractor's accounting system; (2) an overview of written purchasing policies and procedures; (3) purchasing file requirements and standard forms; (4) instructions on required contract clauses (such as those in 5-607); (5) ethics procedures (conflict of interest, gifts, gratuities and anti-kickbacks); (6) a description on the review and approval process; and (7) information on penalties associated with the statutes on false claims and false statements.

5-606.3 Policies and Procedures

Written policies and procedures that encompass the purchasing operation help ensure that (1) delegated duties and responsibilities are formally documented and communicated to employees, (2) specific controls operate consistently from period to period, (3) established purchasing practices are consistent with management's goals and objectives, and (4) are based on authorized requirements. A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial government business. The policies and procedures should include the items as set forth in Attachment 1 to the Standard Audit Program included on the DIIS (also refer to DFARS C-203). When evaluating the contractor's policies and procedures, the auditor should consider whether they:

a. Address all major duties and responsibilities in the purchasing system. They should be comprehensive and easily understood in order to minimize the risk of

errors arising from causes such as misunderstood instructions, and mistakes in judgement. The auditor should be alert for aspects of the purchasing system process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies (e.g., failure to adequately communicate changes in established policies and procedures).

b. Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to adhering to established policies and procedures, and complying with FAR and other applicable regulations. The auditor should carefully assess the level of management approval to determine if it is appropriate given the nature of the duties and responsibilities being assigned. While not inherently indicative of poor policies and procedures, failure to involve an appropriate level of management in the approval process can result in a perceived lack of importance and ultimately a lack of compliance.

c. Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures, but also providing the necessary training to ensure that they understand how to interpret and execute them.

5-607 Contract Clauses in Purchase Orders and Subcontracts

The contractor should have policies and procedures to ensure that all applicable purchase orders and subcontracts contain all flow down clauses, including terms and conditions and any other clauses needed to carry out the requirements of the prime contract. Purchasing personnel must be aware of the distinction between general or standard contract provisions, and those which are special (used only when warranted). Manual or computerized forms may be used with

desk procedures or help menus that explain the criteria used to designate which clauses are special. For clauses that may require special attention, refer to DFARS C-204 and DFARS C-205.4. A legal specialist may assist the CPSR team in performing the clause review.

5-608 Management of Purchasing

The contractor should organize and administer the purchasing department to ensure the effective and efficient procurement of required quality materials and parts at the most economical cost from responsible/reliable sources. DFARS C-205 provides criteria used by the CPSR team to assess the effectiveness of this area.

5-608.1 Organizational Independence

The purchasing department should have an organizational plan which establishes clear lines of authority and responsibility. Items to consider include:

- a. The purchasing department is independent of other departments and is responsible for procuring all materials, supplies, services, and equipment.
- b. The receiving function is performed by personnel independent of the buying function (6-311).
- c. All purchasing department personnel should understand their assigned responsibilities, authority, and limitations.
- d. There should be procedures delegating who has the authority to make commitments and to question quality and quantity of material requisitioned or received. (DFARS C-203.1(c)(1)(i))

5-608.2 Administrative Controls

In addition to controls related to Source Selection (5-609), Pricing/Cost Analysis and Negotiation (5-610), and Subcontract Award and Administration (5-611), management should have the following controls in place over placement and administration of purchase orders:

- a. Purchase orders are based on authorized requisitions (6-308). The requisitions should indicate the specific contract, project, department, or account (i.e., cost objective) to which the materials or services will be charged.

- b. Effective numerical document controls or status registers are maintained to record the receipt of purchase requisitions and the actions taken to accomplish the purchase.

- c. The purchasing department notifies originators of purchase requisitions and other personnel concerned with the receipt of requisitions, the result of purchase actions, and other pertinent matters affecting the purchase.

- d. The purchasing department has adequate controls to prevent the unauthorized use of canceled or voided purchase requisitions.

- e. Purchase orders are prenumbered and all numbers are accounted for.

- f. Purchase orders are specific and complete as to nomenclature, specification, delivery dates, freight, discounts, price, and clauses of any type required by the terms of the prime contract.

- g. Copies of purchase orders are furnished when issued to the receiving and accounts payable functions and when appropriate to the expediting department.

- h. Procedures preclude issuing numerous purchase orders for small amounts.

- i. The purchasing department maintains specifications for all materials and services used by the contractor.

- j. Procedures require complete history files for items purchased frequently and for all major procurements.

- k. The contractor develops alternate sources when possible.

- l. The purchasing department maintains and uses, as a means of effecting economies, price history data and a current copy of a priced bill of materials to ensure that:

- (1) Material specifications recorded on the requisitions and purchase orders match the specifications on the bill of materials;
- (2) Possible economies for ordering required material, recognizing the total needs as reflected in the bill of materials and the stock level requirements, are considered (6-308);
- (3) Nonrecurring tooling/setup, and similar type charges are not paid twice; and

- (4) The price agreed to at the time of purchase is comparable to the price projected in the bill of materials, or that price increases (see 5-610) are fully explained.

m. The contractor has written policies explaining what types of activity are prohibited by purchasing agents (e.g., acceptance of kickbacks).

5-608.3 Purchasing File Data

Purchasing and subcontracting files must be adequately documented so as to provide a complete and accurate history of purchase transactions to support the vendor selected and the price paid. If documentation is not available (i.e., certificate of current cost or pricing data), request an explanation.

Case Files. The contractor should maintain a case file of all pertinent actions affecting each contract and subcontract. In evaluating the adequacy of purchasing files, determine whether the files include:

- a. Copies of the purchase order and requisition, invitations to bid (or requests for proposal), responses to solicitations, resulting subcontracts, and any subcontract changes.
- b. Bid tabulations that summarize and compare vendor quotations.
- c. Vendor surveys of production and financial capabilities.
- d. Certificates for the rent/rent-free use of Government facilities.
- e. As applicable, price and cost analysis to assess reasonableness of the proposed price. A certificate of Current Cost or Pricing Data (FAR 15.804-4) when required in FAR 52.215-24.
- f. Evidence of evaluation and actions taken by the contractor to ensure (1) that the subcontractor has complied with the requirements to submit accurate, complete, and current cost or pricing data as required by FAR 52.215-24; and (2) that where prices are based on "adequate price competition" or "catalog or market prices," these terms are verified to have meaning as defined by FAR 15.804-3.
- g. Records of any negotiations conducted, including justification for the selection of the successful bidder, basis for selection of contract type, and evidence that the contractor used the results of its

examination of the subcontractor's proposal in the negotiations.

- h. Copies of technical data.
- i. Price redetermination or termination data.
- j. Correspondence between the purchasing department and the bidders.
- k. Evidence of Small and Disadvantaged Business enterprise considerations.
- l. Information concerning the use of special terms and conditions and approval thereof.
- m. Written approvals or determinations of the contractor's reviewing authorities.
- n. Administrative Contracting Officer approval of purchase orders when required.

5-608.4 Make or Buy Program

a. The contractor should have make or buy policies and procedures. The contractor's make or buy decisions determine which components, assemblies, subassemblies, or parts are to be manufactured and which are to be purchased. The contractor's decision to manufacture in lieu of purchase may be in the best interests of the company, but not in the best interests of the government. When a contractor decides to manufacture a part or component not normally within its experience or production capabilities or which had been purchased in the past, the basis for that decision and the resulting cost impact should be reviewed. For example, the contractor may desire to gain experience in a particular manufacturing or fabricating process. Another consideration which may influence a contractor's make or buy decisions involves the extent of available idle facilities. FAR Subpart 15.7 requires contractors to develop make or buy programs for certain contracts based on a dollar threshold.

b. As a minimum, consider internal controls related to the following when reviewing make or buy policies and procedures:

- (1) Determine whether the contractor has a formal make or buy committee, organization, or function.
- (2) If a function has been established, ascertain the basis for assigning personnel to the function. Usually, the function

is composed of representatives from various departments, including purchasing.

(3) Review and evaluate the contractor's established make or buy policies and procedures for propriety and acceptability. If the contractor deviates from the established policies and procedures for individual actions, review and evaluate the basis for deviation.

(4) Evaluate the basis for specific make or buy decisions to determine whether the contractor's policies and procedures are reasonable and effectively implemented.

(5) Determine whether procedures are in effect which provide for the prompt notification to the contracting officer of changes in make or buy decisions.

(6) The guidance in 14-600 for capital investments is equally applicable in the review of make or buy determinations.

5-608.5 System Reporting

There should be a system of reports and controls that reflects performance and provides the means through which the purchasing organization reports its performance to company management. For example, the contractor may have a status report reflecting the number of days to furnish supplier quotes and negotiated price data for use in proposal preparation, aging of requisitions, number of purchase orders issued per buyer, on time deliveries, etc.

5-609 Selecting Sources

There should be procedures to provide for the selection of the most responsible and reliable sources for furnishing required quality parts and materials. These procedures should also promote competitive sourcing among dependable suppliers in order to obtain the most reasonable prices from sources that meet contractor quality requirements. (DFARS C-207)

5-609.1 Competitive Sourcing.

In order to ensure acquisition of the least expensive material consistent with contract specifications, the contractor's procedures should provide for bid solicitations from a sufficient number of prospective sources to promote effective competition commensurate with the na-

ture and dollar value of the purchase action. The contractor should use competition to the maximum extent practical.

a. Management should promote competitive sourcing by (1) requiring regular reports on competitive buying which in addition to identifying the number of competitive bids would also identify suspect situations where the lowest bidder may always be the same and always slightly under the next lowest; (2) providing historical part number and vendor data bases; and (3) performing marketing surveys to determine alternative sources.

b. Bidders Lists. The purchasing department should maintain bidders lists or other appropriate reference files of potential vendors who may be solicited for the various items of supply and service required for company operations. These lists aid in locating supply sources and in soliciting competitive bids. The contractor's files should reflect the financial responsibility, technical capability, and history of past performance of suppliers, particularly those from which the contractor has purchased items on a non-competitive basis. A review and evaluation of this area should determine if bidders lists are maintained on a current basis to ensure maximum usefulness.

c. Purchasing Bid Procedures. The auditor's review of purchasing procedures should determine whether:

(1) Bid solicitation procedures provide that (a) all quotations for major procurements are in writing; (b) each prospective supplier is furnished complete sets of specifications for the item or service to be procured, and sufficient lead time is allowed for the preparation of the proposal; (c) the purchasing office establishes case files reflecting a ready record of all actions; and (d) all government directives are reviewed for special considerations concerning small business and labor surplus areas.

(2). Procedures provide for sufficient justification for awarding intracompany purchases or work orders. Files are reviewed independently within the company for any evidence of "bid-matching" on orders issued to affiliates, subsidiaries, or other divisions. In "bid-matching" the buyer waits until outside bidders respond

¶5-609.1c.

and then informs the "inside" company of the low bid (see 6-313).

(3). Procedures provide for justification when the low bidder is not selected.

(4). Procedures ensure that debarred or suspended contractors are excluded from receiving contracts, unless the acquiring agency's head or a designee determines that there is a compelling reason for such action, as explained in FAR 9.405-2, 9.406-1(c), and 9.407-1(d). An important criterion in determining the propriety and allowability of payments for material purchases or subcontracts is the "consent" requirement of specific contracts. FAR 52.244-1 through 52.244-5 are the pertinent solicitation provisions and contract clauses which, if included in a contract, delineate the "consent" requirements by types and categories of contracts. If by the terms of the contract, prior consent is required of the ACO in subcontracting/purchasing, the ACO is prohibited from consenting to award to a debarred contractor. "Consent" here means to consent to contract with a particular entity or person; not consent to make a purchase. If prior consent is not required or if it is required for approval to make purchases only, a prime contractor is free to solicit from any sources available, including debarred, suspended, or ineligible contractors.

5-609.2 Vendor Performance Evaluation

The contractor should have a vendor evaluation system used in the selection of sources. It could provide for the review of price, quality, delivery, technical capabilities, financial capabilities, and service. The contractor should document vendor evaluations on each buy or have a vendor rating system. If the contractor has a rating system, determine its efficiency by reviewing what aspects of performance it rates, who evaluates performance (all knowledgeable people should have input), whether the information is kept current, and how it is used in selecting sources.

5-609.3 Sole/Single Source.

Contractor policies should view each single or sole-source purchase as an exception. The policies and procedures should require justification, cost/price

analysis, if applicable, and approval by a responsible company official. Factors to be considered when evaluating purchases involving noncompetitive items, which could affect the evaluation of the purchasing procedures, are whether (a) the vendor was designated by the contracting officer who awarded the prime contract and (b) the purchase, if made from a sole source supplier, was approved by a responsible company official.

5-610 Pricing and Negotiation

The contractor ensures that some form of price or cost analysis is performed in connection with every purchasing action (also refer to DFARS C-208).

5-610.1 Cost/Price Analysis and Technical Evaluation

a. The contractor should perform cost/price analysis and technical evaluation of its subcontractor's and supplier's proposals/quotations. The scope and conclusions of the analysis should be documented and included in the purchase order file. The contractor should obtain a certificate of current cost and pricing data when applicable.

b. Buyers should document the purchase order file to explain price increases (over previous buys or over bill of material estimates) and lack of decreases in price when circumstances indicate that the price should be lower (when quantity is increased over a previous buy or vendor quote, or when learning or other factors indicate lesser costs than in a previous buy).

5-610.2 Negotiation

The auditor's review of purchasing procedures should determine whether:

a. Buyers are required to negotiate separate price breakdowns for significant elements of the purchase (such as for facilities, tooling, engineering, setup, testing, and special packaging) to allow separate cost control of these significant elements.

b. Prices are established at the time the order is placed for goods manufactured to order, rather than on an "advise price" basis.

c. Procedures require sufficient evidence of negotiation when it is necessary to establish a reasonable price because the item is nonstandard or an insufficient number of bids have been received.

d. Awards have been made to other than the low bidder on the basis of delivery. If so, the purchase order should provide for a downward price adjustment if delivery schedules are not met.

e. The contractor's procedures provide for the timely implementation of repricing clauses included in subcontracts or purchase orders. The contractor's repricing procedures should require that the (1) revised contract prices are negotiated or arrived at as provided by contractual requirements; (2) cost or pricing data which was used as the basis for repricing is current, accurate, and complete; and (3) results of the repricing action are in the best interests of the government.

5-610.3 Purchase Discounts, Quantity and Payment

The contractor is responsible for having a system in place for seeking and taking advantage of cash discounts, trade discounts, quantity discounts, rebates, and freight allowances. The contractor should combine requirements where appropriate. Usually this is part of the requirements system (6-308) at larger contractors. Additionally, contractors may have a corporate purchasing system to provide volume discount advantages for the whole company. The contractor should have a methodology for handling high volume, low value orders, such as subcontracting with distributors, competing long term blanket orders (FAR 13.2) or opened ended subcontracts.

5-611 Subcontract Award and Administration

The contractor ensures the proper types of contracts are selected and that there are controls including oversight and surveillance of subcontracted effort (also refer to DFARS C-209).

5-611.1 Types of Contracts

a. The contractor should have policies and procedures in place for determining the types of subcontracts to be awarded

and under what circumstances they are to be awarded. FAR 16.1 can be used as a guideline when evaluating the contractor's policies and procedures.

b. Unallowable Procurement. Determine whether the contractor's procedures prohibit the issuance of cost-plus-a-percentage-of-cost subcontracts (FAR 44.203(b)(2)). Under this type of procurement, the subcontractor would receive payment for, and the prime contractor would pass on to the government as cost of its contract, the costs incurred in performing the contract, plus a specified percentage of such costs as a profit or fee. Thus, the fee would increase in direct proportion to any increase in cost.

5-611.2 Subcontract Surveillance

Administration of Subcontracts. Advantages gained by prudent and capable efforts in planning and negotiating subcontracts can be dissipated through the failure of upper-tier contractors to administer subcontracts properly. Upper-tier contractors must be aware of the progress of the subcontracts to ensure timely delivery of an acceptable product. When the subcontract is other than firm-fixed price, the upper-tier contractor must also maintain surveillance over subcontract costs to keep current with the financial aspects of the upper-tier contract. The cognizant auditor should review and evaluate the upper-tier contractor's policies and practices pertaining to the administrative and technical controls exercised over delivery schedules, change orders, modification notices, and overall costs. The contractor should have a policy and procedures for alerting the government on award of all auditable subcontracts (those requiring interim and final audits) and a method for notifying the government of potential significant subcontract problems that may impact delivery, quality, or price.

a. In evaluating the upper-tier contractor's procedures for controlling delivery schedules, determine whether (1) some form of register or control is maintained to "flag" delivery due dates; (2) procedures are in effect to expedite delivery of subcontract material, particularly when it is apparent that the supplier will not meet the established delivery date, or is in fact

delinquent; and (3) corrective action is taken when the supplier is delinquent in delivery schedules including, where appropriate, adjustment of the purchase price.

b. In evaluating the upper-tier contractor's procedures for controlling change orders and modification notices, determine (1) if the upper-tier contractor evaluates the delivery schedules when engineering changes have been introduced; (2) the timeliness of notification from the upper-tier contractor to subcontractors when modifications are introduced into production; and (3) the adequacy of the action taken by upper-tier contractors when change orders or modification notices affect cost.

c. The evaluation of the upper-tier contractor's procedures relative to cost controls should be directed to the (1) production and financial controls, with emphasis on those controls which ensure that physical progress of production is commensurate with reimbursement; (2) timeliness and adequacy of the repricing action when production is performed under redeterminable subcontracts (including a determination of the timeliness of recoveries resulting from downward repricing actions); (3) propriety of the costs generated by the subcontractor, particularly when the upper-tier contractor is also a subcontractor to the same or a lower-tier subcontractor; and, (4) review of progress payments (refer to 5-1107.7 billing system review of subcontractor progress payments).

d. In evaluating the upper-tier contractor's procedures for adequate documentation, determine whether contractor representatives are required to prepare trip reports covering each visit to a subcontractor. Procedures should require timely reporting of significant and relevant issues including additional funding actions and status of physical progress in relation to costs incurred. Subcontractor financial reports should be adequately supported by trip report documentation.

e. Subcontract Changes. Procedures should be in place to document and justify the reasons for subcontract changes which affect cost or price. The government is at risk, when the cost of the subcontract, before the change, has exceeded or is expected to exceed original estimates. Lack of adequate procedures could result in changes which have been overpriced to avoid an overall loss or to provide total profit or fee in accordance with original contract estimates.

f. Audit of Subcontracts. Timely consideration of redeterminable, incentive, and cost-type subcontracts is essential to the audit of upper-tier contracts. The government's interest in these types of subcontracts is similar to its interests in costs of variable-price prime contracts when the subcontract awards are made in a chain unbroken by a firm fixed-price subcontract. When the upper-tier contractor proposes to audit records of a subcontractor, evaluate (1) the procedures which address the extent of coordination between the contractor's purchasing and audit function; (2) criteria established by the contractor for waiving audits; (3) established procedures for ensuring that the government is notified when access to subcontractor records is denied the upper-tier contractor (6-800); (4) independence and qualifications of the contractor's auditors; and (5) adequacy of their audit programs and working papers (see also 4-1000). Procedures should ensure that adequate controls are maintained for early identification of auditable subcontracts (see 6-802).

5-612 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

5-700 Section 7 — Audits of Contractor Material Management and Accounting Systems (MMAS)**5-701 Introduction**

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

b. This section provides audit guidance for reviewing and evaluating the contractor's internal control structure for material accounting (5-100) and compliance with DFARS 252.242-7004, Contractor Material Management and Accounting Systems (MMAS). If a contractor does not have contracts that include DFARS 252.242-7004, this audit guidance can be used to determine if the contractor's MMAS meets CAS and FAR requirements.

5-702 Background Information

MMAS can range from highly automated to manual systems. The requirements of DFARS 242.72 apply equally to automated or manual systems. MMAS are normally comprised of a material requirements planning (MRP) system and material accounting systems. For background information, MRP systems are briefly discussed, as follows:

a. Many contractors have an automated system for determining requirements. A material requirements planning (MRP) system is a system for identifying requirements, initiating procurement, and maintaining current and future materials necessary to support production operations. Hence, MRP is a method of inventory control, not inventory costing. However, an MRP system does initiate inventory transactions and provides information used for costing those transactions. It takes into account the specific timing of material requirements, with the objective of minimizing inventory investment consistent with meeting a given production plan. An effective MRP system will result in having the optimum amount of material available for planned production. Consequently, a contractor's investment in inventories is minimized.

b. MRP system configurations can vary depending upon needs. However, the following features are common to all designs:

- (1) Highly Automated Systems. Extensive use of electronic data processing (EDP) enables MRP systems to react instantly to changed conditions.
- (2) Balance of Requirements (often referred to as RQ) and Replenishments (often referred to as RP). MRP systems maintain a balance between all the requirements for a part and all the replenishments for the part. Replenishments generate the need for procurement actions or releases to production for the needed parts. The replenishments can be in various stages of completion or can be available from stock. A requirement may be a record for a deliverable item (independent RQ) or a record for a requirement to be consumed in a next assembly (dependent RQ). Key data ingredients in each requirement record are the required quantity, need or schedule date, and requirement origin (i.e., contract spare item, shipping date).
- (3) Netting Process. The netting process involves comparing requirements with replenishments to determine the need for parts. It begins with the total bill of material for the requirement for each specific part being netted. If the requirement is for an assembly, each part incorporated into the assembly must be separately netted. The system nets requirements against the replenishments for that part. The most basic form of the netting formula is:

STATUS OF A PART = Replenishments less Requirements

If status is zero, replenishment and requirements are in balance.

If status is negative, then replenishments are needed.

If status is positive, then excess replenishments (parts) exist.

- (4) **Dynamic Rescheduling.** Dynamic rescheduling of all items in the production process can result from a timing change or an introduction or deletion of items in the production process. Depending on location, the rescheduling may be automatic or may require a manual "go/no go" decision. Changes in schedule may result in different numbers of requirements, replenishments, or both. The timing difference will change the status of the netting formula.

5-702.1 DFARS 242.72

a. DFARS 242.72 and the related MMAS contract clause (DFARS 252.242-7004) prescribe policies, procedures, and standards for use in the evaluation of a contractor's material management and accounting system (MMAS). This DoD FAR supplement requires applicable contractors to assess their MMAS and take reasonable action to comply with MMAS standards. Considering applicability requirements some contractors may also be required to disclose their MMAS and demonstrate compliance with MMAS standards. The cognizant auditor should advise and assist the ACO in evaluating both the contractor's MMAS and the contractor's correction of any deficiencies.

b. DFARS 242.72 requires most contractors that receive cost-reimbursement prime contracts and/or fixed-price prime contracts (with progress or other financing payments) to conform to MMAS standards. Contracts awarded under the set-aside procedures of FAR Part 19 and contracts under the small-purchase threshold set forth in FAR Part 13 are exempted. Additional disclosure and demonstration requirements are as follows:

- (1) Specific requirements to disclose MMAS and demonstrate compliance apply to any large business contractor that received DoD

prime contracts or subcontracts totaling \$50 million or more in its preceding fiscal year.

- (2) For contractors that received prime contracts or subcontracts of \$10 million or more (in the preceding fiscal year) but less than \$50 million, the ACO can request MMAS disclosure and demonstration.
- (3) The demonstration and evaluation requirements do not apply to small businesses, educational institutions, or nonprofit organizations.

c. DoD policy stipulates that all contractors must have an MMAS that reasonably forecasts material requirements, assures proper charging and allocation of purchased and fabricated material (based on valid time-phased requirements), and maintains a consistent, equitable, and unbiased logic for costing of material transactions. The MMAS contract clause (DFARS 252.242-7004(f)) specifies that MMAS must have adequate internal accounting and administrative controls to assure system and data integrity and must comply with ten specific MMAS standards.

d. For contractors required to disclose and demonstrate compliance of their MMAS, DFARS 252.242-7004(d) provides system disclosure, demonstration, and maintenance requirements.

(1) MMAS disclosure is adequate when the contractor has provided the cognizant ACO documentation which accurately describes MMAS policies, procedures, and practices in sufficient detail for the government to reasonably make an informed judgment regarding the adequacy of the contractor's MMAS currently being used. Anticipated changes to the existing system would be subject to future audits after implementation and demonstration. Significant changes to the MMAS must be disclosed to the cognizant ACO within 30 days of their implementation per DFARS 252.242-7004(d)(4).

(2) An MMAS demonstration is adequate when the contractor has provided the cognizant ACO sufficient evidence to demonstrate the degree of conformance of its MMAS to MMAS standards. This demonstration will include an estimate of

the cost impact to the government of any significant deficiencies and a comprehensive plan for correcting such deficiencies.

5-703 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy to assist the ACO in evaluating the contractor's MMAS. When appropriate, DCAA should provide the ACO with an assessment of the significance of contractor deficiencies and an estimate of the resulting adverse material impact to the Government. Also, DCAA should assist the ACO in evaluating the contractor's correction of deficiencies.

c. DFARS 242.7205 requires that cognizant contract administration and audit activities will jointly establish and manage programs for evaluating the MMAS of contractors subject to disclosure, demonstration, and maintenance requirements (see 5-702.1b). MMAS reviews should be accomplished as a team effort with a team leader appointed by the ACO. These reviews should be conducted at least every three years, except where the ACO (in consultation with the auditor) determines that experience and vulnerability assessment disclose a low risk. If the ACO determines the government is subject to high risk, MMAS evaluations should be done more frequently.

c. The guidance contained in the following paragraphs can be applied to contractors who are not subject to the disclosure, demonstration, and maintenance requirements. However, prior to initiating any such review, the auditor should coordinate with the regional audit manager and cognizant ACO.

5-704 Audit Objectives

a. The purpose of the audit is to express an opinion on the adequacy of the contractor's MMAS internal controls and determine the cost impact, if any, resulting from any system noncompliance. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

The MMAS standards are stated in DFARS 252.242-7004(f).

b. Where the contractor is required to disclose its MMAS and demonstrate compliance with MMAS standards, the auditor should determine the level of reliance that can be placed on the work of others (CAM 4-1000). Under these circumstances, the contractor has the responsibility to provide sufficient evidence to demonstrate the degree of conformance with MMAS standards. Auditors should not undertake any extensive review of the contractor's MMAS without receiving an adequate demonstration by the contractor.

c. The auditor is responsible to review the contractor's demonstration and to scope the audit to meet the objective of determining compliance with MMAS standards. If the contractor refuses to provide an adequate demonstration, the auditor (after a reasonable period of time) should notify the ACO for assistance to get the required disclosure and demonstration. Actions which could be considered by the ACO would include reductions or suspension of progress payments under FAR 32.503-6, disapproval of the contractor's cost accounting system and/or cost estimating system, and/or recommendations concerning award of future contracts. The auditor should implement audit steps to identify the potential harm to the government as the basis for any recommended ACO withholding.

(1) The FAO and ACO must coordinate with the contractor as early as possible, preferably at the time of requirements planning. This early coordination should assure an understanding of government expectations, audit timing, and methods for system disclosure/demonstration.

(2) The auditor should keep in mind that the DFARS requires contractors to have a compliant system and to subject that system to periodic oversight. Therefore, a demonstration should not be a significant task of self-assessment and system enhancement when the ACO asks for a demonstration. It should simply be a process of identifying existing system descriptions, procedures, controls, and

the periodic contractor testing that has been done.

d. For contractors that do not have contracts containing DFARS 252.242-7004, MMAS audits will be conducted when material costs are significant and vulnerability assessments project the need. The objective of the audit is to determine if the contractor's MMAS adequately conforms to CAS and FAR requirements as amplified by MMAS standards. In these circumstances, the auditor should conduct an audit to determine the degree of compliance with MMAS standards. For any noncompliance disclosed, the report will identify appropriate FAR/CAS citations and pertinent contract clauses.

5-705 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business and audit risk (materiality and sensitivity), the scope should be consistent with the guidance in 5-105. DFARS 242.7205 states that evaluations of the contractor's MMAS will be done as a contract administration office and contract audit team effort; therefore, the scope of audit must be coordinated closely with the ACO. The evaluation will be based on the disclosures provided by the contractor, transaction testing and other testing as necessary.

(1) Where the contractor meets the thresholds in DFARS 242.7203, the contractor's MMAS demonstration should include sufficient evidence to show its compliance with the standards in DFARS 252.242-7004.

(2) Where the contractor does not meet the thresholds in DFARS 242.7203, the auditor should request that the contractor provide the results of any system testing which has been done (see 5-715).

(3) In determining the scope of audit, the auditor should consider how much reliance can be placed on the contractor's transaction testing and disclosure of internal controls (CAM 4-1000).

b. The auditor should also review completed audits related to MMAS, including as a minimum:

(1) Billing system reviews

(2) EDP reviews (general and application controls) of MMAS

(3) Estimating system reviews

(4) MMAS operations audits

(5) Material incurred cost reviews

(6) Defective pricing reviews

(7) Contractor purchasing system reviews

c. The auditor should coordinate with DCAA offices (at other contractor divisions/segments), the ACO, and the contractor. To ensure positions and interpretations are consistent, the FAO should contact the CAC, CHOA, or other segment FAOs to determine similarities of systems among segments, deficiencies found at other divisions, and interpretations of compliance/noncompliance to specific standards. Coordinate the audit with the ACO to assure full understanding of the overall scope and areas of responsibilities. Since the review deals primarily with financial and accounting issues, the ACO should be encouraged to assign DCAA as the team leader. Further, the auditor should coordinate closely with other responsible government representatives such as government property specialists and engineering and other technical representatives. Team tasks must be clearly defined to take advantage of the available government expertise and mission requirements of all members. Most important, the team must make every effort to avoid duplication of effort. Early discussions with the contractor should be established to assure adequate demonstrations in a reasonable period. Before scheduled demonstrations, be sure that the contractor and ACO have a good understanding of what is expected in terms of the format and timing of the demonstration and the expected level of detail (including sufficient evidence).

5-705.1 Inadequate or Delayed Demonstrations

a. DFARS 252.242-7004(d) requires contractors to disclose their MMAS in enough detail for the government to make an informed judgement regarding its adequacy. The DFARS also requires contractors to provide the cognizant ACO sufficient evidence to demonstrate the degree of conformance of its MMAS

to the standards. To be adequate, the demonstration will include an estimate of the cost impact of any significant deficiencies and a comprehensive plan for correcting such deficiencies. Audit considerations related to each of the 10 MMAS standards are discussed in the following paragraphs.

b. If the contractor is unable to demonstrate its system or is unreasonably delaying its demonstration, and the FAO has identified potential harm relative to premature or excess billings, calculate any estimated harm to the Government and recommend the ACO implement a withhold to protect the Government's financial interests. The following steps could also be used to help scope the audit at contractor locations where a demonstration is not required; however, in this case the recommendation to withhold should be part of the final audit report.

(1) Review current inventory to identify materials that are in excess of known requirements by comparing the contractor's listing of contract requirements (parts lists, etc.) to the on hand inventory.

(2) Review the material months on hand, e.g., date received to the date of usage, to determine if materials appear to be unreasonably time phased.

(3) Review contractor inventory cycle count data if available or sample inventory to determine the level of record accuracy.

(4) Sample material transfer activity to determine if transfers of costs or loan payback procedures resulted in noncompliance with MMAS Standard 7 and increased or duplicated costs to the Government.

(5) Tailor other steps that would identify potential harm to the Government based on leads or information available to the FAO.

(6) Notify the ACO of the demonstration problems and identify deficiencies found in the above steps.

(7) Recommend that the ACO withhold the amount of the potential impact to the Government (the effect of the identified procedural and/or control deficiencies) identified through the above steps until the contractor provides an adequate demonstration of its MMAS

which specifically identifies the level of compliance and applicable cost impacts. See CAM 5-716 and MMAS training course no. 1292 for guidance on computing cost impacts.

5-706 System Description

MMAS Standard 1 (DFARS 252.242-7004(f)(1)). This standard requires the contractor to provide an adequate system description including policies, procedures, and operating instructions compliant with FAR and DFARS. While the contractor is required to provide a broad range of documents, the auditor should focus attention on the adequacy of the policies, procedures, and operating instructions related to MMAS Standards 2 through 10.

a. The contractor should establish and maintain descriptions of the major manual and automated systems that comprise the MMAS. These descriptions should cover all integrated component systems and include:

- (1) narrative descriptions of each of the component EDP systems and the interaction with one another,
- (2) detailed flowcharts for each of the component EDP systems,
- (3) identification and purpose of all MMAS related transactions, tables, schedules, files, and reports for each component EDP system,
- (4) descriptions of available historical data files, retention periods, and storage format, and
- (5) identification of the programming languages used to implement, process, and query the system.

b. The contractor should provide a written description of its MMAS in enough detail to allow the auditor to get a thorough understanding of how the MMAS operates. The contractor's write-up should include references to written policies, procedures, and operations manuals. Information should be provided for each process or function within the system as well as existing internal controls.

c. The system write-up should identify the generation of material requirements, bills of material, and development of lead times. The contractor should provide

information on how this information is used to purchase material. All data input (whether manual or automated) should be identified. This should include a description of how the material is:

- (1) ordered and tracked once a purchase order is issued;
- (2) tracked once it arrives at the contractor's warehouse or plant;
- (3) handled and accounted for in storage locations;
- (4) issued to a task;
- (5) billed to the government;
- (6) accounted for when it is moved among tasks or inventories and incorporated into the end item; and
- (7) disposed of during contract performance and at contract completion.

5-707 Material Requirements

MMAS Standard 2 (DFARS 252.242.7004(f)(2)). MMAS Standard 2 requires contractors to assure that purchased and fabricated material charged to contracts are based on "valid time-phased requirements." Costing practices are valid and time-phased when material is purchased and/or fabricated for a specific production plan and the cost is charged and billed within a reasonable time related to production process needs.

a. There is no standard number of days (months) that constitute adequate time phasing. Time phasing is the product of good material management and internal controls. Reasonable time phasing ensures all material management processes are justified and followed. In turn, material management processes should ensure that materials are received as close to manufacturing need dates as possible under existing circumstances.

b. The auditor's primary goal is to determine that sufficient procedures and controls are established to assure contracts are charged based on valid time-phased requirements. The standard specifies accuracy goals as a validity measure to assure that the Bill of Material (BOM) or master production schedule (MPS) reflects the most accurate, complete, and current information. The auditor should gain an understanding of the contractor's system and controls to evaluate the con-

tractor's system demonstration. The auditor should review EDP related policies and procedures which address the system's automated operations. Current flowcharts of the material time-phasing process and the processes used to determine BOM and MPS accuracies should be reviewed, analyzed, and a conclusion made regarding the adequacy of the automated process. Internal controls over access to component EDP systems should be reviewed to determine that only users needing access to perform their duties are allowed onto the system. Data entry sources and related material system transactions should be identified and their applicable security system authorization tables examined to determine that transaction authorities (e.g., read, update, delete) are adequately controlled.

c. Auditors must be alert for situations where the contractor's current systems are accurate (the BOM system is generating valid requirements and the MPS system is identifying accurate material need dates) but contracts include invalid or unreasonably time-phased materials. However, this should be the exception—an accurate system should generate valid time-phased material costs. Even though the current system is functioning accurately, prior deficiencies or other circumstances may have allowed invalid or unreasonably time-phased materials to be charged to the contracts. This would be noncompliant with the objective of the standard if controls were not instituted to relieve the government of the impact of this unallowable practice.

d. The auditor should verify contractor use of the BOM and MPS as a basis for material costing and review measures of performance that assure charges or allocations are based on valid time-phased requirements. Standard 2 states that a 98 percent BOM accuracy (see paragraph 5-707.1d for discussion on the accuracy calculation) and a 95 percent MPS accuracy (see paragraph 5-707.2b for discussion on the accuracy calculation) are desirable goals to assure that requirements are valid and time-phased. If the system accuracy is lower, the contractor must demonstrate that there is no material harm to the government and/or the cost to meet the accuracy goals is exces-

sive in relation to impact on the government. Reviews of the BOM and MPS require close coordination with government technical representatives.

e. As the auditor reviews the 10 MMAS standards, observations in other areas may provide indicators of problems with the MPS and BOM. A large number of material expeditors, substantial excess inventory, and frequent inventory shortages can all be strong indicators that formal MPS and BOM systems are not providing accurate information or that established policies and procedures are not being followed. These circumstances can also be indicators that the contractor is operating under an informal system and ignoring problems reported by formal MPS and BOM systems. This can lead to problems with excess inventory and financing of material far in advance of need.

5-707.1 Bill of Material Accuracy

a. Requirements are considered valid when material is purchased or fabricated to provide quantities necessary to complete specific production units. The bill of material (BOM) identifies materials and quantities required to manufacture the assembly. An accurate BOM represents contractually required materials. By combining the requirements for the various assemblies, the contractor can determine total contract requirements. Total requirements can then be compared with material charges to the contract. This process can identify the existence of costs that:

- (1) are not based on requirements
- (2) exceed contract requirements
- (3) represent requirements for which no costs have been incurred

b. The contractor should have BOM policies and procedures addressing:

- (1) BOMs for assemblies and fabricated parts that generate requirements
- (2) the development of original material requirements and subsequent changes
- (3) approval authority for releasing and maintaining bills of material
- (4) material requirement adjustments for engineering changes
- (5) controls for converting engineering BOMs to manufacturing BOMs

(6) materials used on an "as required" basis (no specified quantity requirement)

(7) substitute material to include controls that prevent requirements from being input for both primary and substitute materials

(8) how and when bills of material records are maintained and purged

(9) a reasonable basis for measuring the accuracy of the bill of material

c. The contractor's system should provide for systematic testing of the bills of material for accuracy, appropriate corrective measures as warranted, and a record of the results of such tests.

d. The techniques for calculating the accuracy percentage for BOMs will vary from contractor to contractor. The technique used is dependent on BOM preparation methods and the production process. BOM accuracy indicates whether the BOM represents the actual material required to produce the product. Using traditional methods, material requirements on an "as-built" basis is the best measure of accuracy. However, the BOMs which are loaded into the system and drive purchase and fabrication orders are the ones affecting billing and costing. These BOMs are the most appropriate for measuring to assure they reflect the most current, accurate, and complete information. The contractor should have procedures and internal controls for ensuring accurate BOMs and a reasonable method for calculating BOM accuracy. An example of one formula follows:

$$\text{BOM Accuracy} = \frac{\text{BOMs in Agreement}}{\text{Total BOMs Reviewed}} \times 100 = \text{ } \%$$

e. Each level of production (i.e., fabricated parts, subassemblies, assemblies, and line replaceable units) has BOMs that may be tested for accuracy. BOMs can be inaccurate at any level. In order for the auditor to assess BOM accuracy, selected BOMs must be compared to appropriate data (e.g., engineering BOM, part drawings, engineering changes) to ensure that 98 percent of the BOMs driving procurement are accurate. Necessary adjustments for the actual calculation of the BOM accuracy must be made as circumstances warrant.

5-707.2 Master Production Schedule Accuracy

a. The contractor should have a document(s) that represents the master production schedule (MPS). The MPS details what and how much material, labor, and capacity is required and when these resources are needed. The contractor should have MPS policies that address:

- (1) level of approval and identification of approving official
- (2) whether or not past due effort is allowed (past due effort is unplanned effort and should be re-scheduled)
- (3) methods for evaluating reasonableness of capacity constraints
- (4) definition of planning horizon and identification of planning time increments.
- (5) techniques for systematic testing for accuracy and appropriate corrective measures, as warranted
- (6) procedures and identification of authorities for changing policies
- (7) methods for periodically verifying the reasonableness of lead and flow times
- (8) timely processing of changes
- (9) product changes being planned and implemented to minimize disruption to the master schedule, scrap, rework, and obsolete material

b. An accurate MPS and related policies and procedures should provide time phasing of production materials. The techniques for calculating the accuracy percentage for MPS will vary, depending on the method used to prepare the MPS and the nature of the production process. Although there are some common methods used for measuring MPS, no specific method is required. Each contractor should assess its own system and then identify the most appropriate method to demonstrate that the system generates realistic need dates for material. Traditional MPS accuracy measures consider historical performance by comparing end item deliveries accomplished versus end item deliveries planned for a given time period, determined as follows:

$$\text{PERFORMANCE} = \frac{\text{ACTUAL PRODUCTION}}{\text{PLANNED PRODUCTION}} \times 100 = \text{--- \%}$$

c. The accuracy measure must be supported by an adequate demonstration of

the reliability of the schedules being measured. The contractor should identify the various lead times and process flows and show the justification for times used. This includes a demonstration that the data used in the MPS is consistent with actual shop floor practice. The demonstration should include all processes that contribute to timely scheduling of material receipts and end item completion at the point that the measure is taken. The contractor is expected to establish a reasonable basis for accuracy measurements, and a program for on-going measurement and improvement of accuracy levels to reach desired accuracy goals.

d. Another example of a measure of MPS accuracy is:

$$\frac{\text{No. of End Items with Accurate Delivery Dates in Schedule}}{\text{No. of Contractually Deliverable End Items}} \times 100\% = \text{MPS Accuracy}$$

In this example, the contractor will determine the universe of contractual end items and their applicable delivery dates. Once the universe is identified, a determination is made as to whether these contractual end items are included in the schedule and that the schedule reflects contractual due dates. When basing the measurement on prospective contractual end item delivery dates as shown in the above example, be aware that contracts may allow a "window" in which to deliver or allow early delivery of contractual end items.

e. The auditor should ensure that these types of measures are not misleading. The critical points are the accuracy of the lead and process times used in the schedules being measured. Before these types of measures can be of value, the contractor must demonstrate the accuracy of the data within the schedules and its consistency with practice.

f. The auditor should evaluate the reasonableness of whatever measure the contractor chooses to employ and render a judgement on whether that measurement appropriately depicts the schedule accuracy and assures that materials required in the manufacturing process will be reasonably time-phased to need in the manufacturing process. In addition, the

contractor and auditor should evaluate the reasons for identified variances to determine the causes of inaccuracies.

g. To assure that contract costing or billings are time-phased, the contractor's demonstration should analyze and demonstrate inventory turnover and/or "months-on-hand" of current inventory. The techniques for demonstration will vary from contractor to contractor. The auditor should evaluate the reasonableness of whatever approach the contractor chooses to employ and render a judgment on whether or not the contractor has adequately justified materials carried for long periods of time. In addition, the contractor and auditor should evaluate the reasons for premature costing or billings to determine the cause and any potential harm to the government.

5-707.3 Justification of Exceptions

a. Even though the contractor's system achieves the desired BOM and MPS accuracy levels, it is possible for invalid or unreasonably time-phased material to get into contract costs and current billings. These situations can be caused by prior system deficiencies that have not been corrected, minimum buy requirements, or other circumstances. Therefore, it is important that the contractor have policies and procedures in place to identify when such situations may exist, investigate the causes, and take necessary corrective actions to ensure that the government is not over billed.

b. The contractor should have controls in place to identify situations where materials are charged to government contracts in excess of contract requirements or significantly before production need dates. While these conditions are not necessarily unreasonable, it is important that they be identified and investigated to ensure that the MMAS is continuing to operate effectively. In addition, the contractor should ensure that the government is not billed for unreasonable material costs.

c. For example, because of minimum buy and/or economic order quantity restrictions for some items of material, material quantities greater than valid time-phased requirements may be purchased or fabricated and charged to a

cost objective. In these instances, the contractor should demonstrate that its method reduces overall costs of purchases and fabrication and that receipt and costing of the materials is done as close to the need date as possible to take advantage of available price reductions. Normally, the contractor should not charge contracts for materials when a requirement does not exist. However, consideration must be given when minimum buy or other necessary circumstances are imposed on the contractor to buy greater quantities than immediately needed.

5-708 System Monitoring

MMAS Standard 3 (DFARS 252.242-7004(f)(3)). Standard 3 requires the contractor to provide a mechanism to identify, report, and resolve system control weaknesses and manual overrides. As with any system, sufficient internal controls should exist so any significant irregularity will be identified through normal system operation. The MMAS system should include policies and procedures that describe how and when operational exceptions are to be identified, reported, and resolved. Operational exceptions are irregular situations that result from system logic (analysis and correction of errors and irregularities) or system overrides.

a. The standard specifically cites excess inventory as one area that needs control mechanisms. The system should identify excess inventory as soon as known. MRP activity can mask any excess by constantly causing it to be moved because of new requirements or changed priorities.

b. Experience has shown that inappropriate costing can result from contractor use of excess inventory on spares contracts. Excess parts are sometimes used on spares contracts at no cost (i.e., never transferring the cost or the replacement part), understating actual recorded contract costs on the gaining contract and overstating cost on the losing contract. Further, nondisclosure of such activity (i.e., proposing purchase or fabrication costs when the parts will be used at no cost) at spares contract price negotiation could result in defective pricing.

c. While reporting mechanisms for excess/residual inventory are critical ones, they are not the only exceptions or problems the auditor should be concerned with. The auditor should look at the contractor's entire exception reporting system to verify the existence, and adequacy, of major controls in all areas that need to be identified. These areas include, but are not limited to:

- (1) unauthorized changes to BOMs;
- (2) materials charged to contracts in excess of requirements;
- (3) materials charged to contracts prior to its production need date (time-phasing);
- (4) monitoring of attrition, rework, scrap, and lost/found material;
- (5) transfers and loan/paybacks; and
- (6) manual overrides (i.e., material adjustments).

d. The most common method used by contractors to facilitate the identification of system irregularities, or problems, is the "exception report." The auditor should obtain a listing of all exception reports and their usage. If there are a significant number of exception reports that are either no longer in existence or not currently used, this should be brought to management's attention.

e. The contractor's policies and procedures should address the resolution of reported exceptions. To be fully compliant with the intent of this standard, the contractor should do whatever is necessary to prevent exceptions, where feasible, or at least minimize their recurrence.

5-709 Audit Trail

MMAS Standard 4 (DFARS 252.242.7004(f)(4)). This standard requires adequate MMAS audit trails and necessary records to evaluate system logic and to verify through transaction testing that the system is operating as desired. The auditor should determine that (a) all original entries and subsequent transactions are recorded in the system, (b) there is an appropriate audit trail, and (c) sufficient evidential matter exists to allow the expression of an audit opinion.

a. All transactions, both original and subsequent entries, should be recorded in the system to enable verification of sys-

tem performance. The auditor should be alert for situations where entries, especially adjustments, can be entered into the system without evidence of the entry being recorded. The contractor should identify each type of transaction covered by the MMAS and the controls for ensuring that these transactions are properly recorded in the system.

b. An audit trail refers to the ability to trace transactions from their authorization through any intermediate books and records to the books and records of final entry, and vice versa. The contractor should be able to show how both purchased and fabricated parts flow through its system from beginning to end. At a minimum, the auditor should trace a few transactions through each significant aspect of the contractor's system. If this effort was accomplished to support the auditor's basic understanding of the system it need not be duplicated here.

c. The contractor must be able to provide sufficient evidence, through transaction testing, that its MMAS system is reliable. To fully comply with this standard, the contractor's system should provide for periodic transaction testing to ensure that the system is continuing to operate as designed. This testing may be included as part of Standard 10.

d. The auditor should carefully assess the adequacy and sufficiency of the contractor's transaction testing and revise the scope of audit accordingly (see CAM 4-1000). In addition, the contractor's transaction testing may fulfill some or all of the required substantive testing necessary to issue an opinion on the allowability of incurred material costs. Therefore, the nature and results of the contractor's testing efforts should be considered in scoping the extent of our annual evaluation of incurred material costs (see CAM 6-300).

5-710 Physical Inventories

MMAS Standard 5 (DFARS 252.242-0046(f)(5)). The main objective of this standard is the requirement to maintain accurate recorded inventory validated through periodic reconciliation of recorded to physical inventory quantities. This will help to ensure that purchases do not

exceed requirements, progress payments are based on valid inventory records, and physical inventory information is accurate for estimating and pricing purposes. The standard specifies 95 percent accuracy as a desirable goal. If this accuracy goal is not achieved, the contractor must demonstrate that there is no harm to the government or that costs to meet the goal are excessive (considering the potential harm to the government). See CAM 6-306 for additional guidance on physical inventories.

5-710.1 Receipt and Inspection of Material

a. The contractor should establish and maintain policies and procedures for receipt and inspection of material. The receiving activity is responsible for the receipt and inspection of incoming materials and the movement of these materials to the areas where the storage and usage functions are carried out. Common responsibilities include:

- (1) unloading, unpacking, identifying, sorting, and verifying that the quantity and quality of materials received agree with purchase order requirements
- (2) noting shortages, damage, and defects
- (3) reporting receipts and discrepancies
- (4) moving materials to storage or other appropriate activities
- (5) providing appropriate transaction inputs to the inventory requirements and accounting systems

b. In evaluating internal controls, as a minimum determine the following conditions and procedures are used as a means of controlling the activities of the receiving and inspection department:

- (1) The receiving function is independent of the purchasing, invoice processing, and shipping functions.
- (2) Incoming material is centrally controlled.
- (3) Receiving reports, signed by an authorized representative, are prepared for all material received, and a copy is furnished to the accounting department.

- (4) The receiving department is advised, by copy of the purchase order, of the type of material purchased.
- (5) Quantities of materials received are verified by actual count, weight, or measurement by the receiving department.
- (6) Quality inspection is evidenced by inspection reports, notations on receiving reports, or other acceptable records.
- (7) Procedures are in effect which control defective and damaged material, overshipments, returned material, material received but not ordered, and claims against carriers and vendors, with related responsibilities for the issuance of debit memorandums.
- (8) Where the contractor accepts and reworks defective vendor-furnished material instead of rejecting and returning it, government contracts are not charged with the cost of rework, unless this is clearly justified in the circumstances.
- (9) Material returns are routed to the shipping department and are controlled by authorized shipping advises or material releases.
- (10) Procedures are in effect for controlling the distribution of material from the receiving area to stores or to production areas.
- (11) The flow of accounting documentation is controlled by use of prenumbered forms, batch transmittals and/or other appropriate means.

c. The pervasiveness of modern EDP systems requires the auditor to obtain reasonable assurance that the authority of data origination, accuracy of data input, integrity of processing, and verification and distribution of output within the receiving and inspection functions are adequately controlled. The results of the most recent EDP general internal control audit and other related systems audits should be reviewed for reported deficiencies which could adversely impact internal control of the receiving and inspections functions. The following elements should be considered when reviewing internal controls related to automated

material receiving and inspection systems:

- (1) The contractor's representation of receiving and inspection systems internal controls. This representation should include identification of system transactions and related security, material processing and exception reporting, inspection processing, adjustments, etc. System operation and the identification of all related system policies, practices, and procedures.
- (2) The number of employees having access to material and inspection system data should be reasonable and based on need. Adequate security controls (logical and physical) should be incorporated to control access to the system and to control specific material transaction capabilities. Authority to make changes to receiving and inspection data should be limited, logged, and closely monitored.
- (3) Current receiving and inspection system/subsystem flowcharts showing data input characteristics, internal control points, internal control tables, and output reports. System operation should be verified to the policies, practices, procedures, and flowchart.
- (4) Test system internal controls by tracking selected receipt transactions to their source purchasing documents. Verify the results of the test to the related bills of material or contract. Any differences must be resolved with the contractor. Consider using CAATs to expedite the process.

5-710.2 Storage and Issuance of Material

a. The storing and issuing function is responsible for:

- (1) Protecting and preserving material in storage, including appropriate safeguards for items of a sensitive nature and items subject to deterioration by the elements.
 - (2) Accessing fast moving items.
 - (3) Examining material requisitions for the appropriate stock number, nomenclature, and authorized usage.
 - (4) Substituting, if appropriate, another item when a requisitioned item is not available.
 - (5) Issuing material timely when presented with an authorized requisition.
 - (6) Initiating purchase requisitions when stock levels reach the reorder point or when authorized requisitions cannot be filled, duly noting due-ins and due-outs.
 - (7) Reviewing stock for slow moving items and items in long supply and initiating appropriate action for consumption or disposal.
 - (8) Providing appropriate transaction inputs to the inventory requirements and accounting systems.
- b. In evaluating the internal controls in this area, determine the extent to which the contractor employs the procedures listed below:
- (1) separate accountability is maintained for contractor-owned and government-owned materials for each class of material
 - (2) material received is delivered directly to the warehouse, storeroom, or production area, via an inspection area if appropriate
 - (3) when material received is delivered directly to a production area, procedures insure that proper documentary and accounting control is maintained
 - (4) excess stock is not permitted to accumulate in production areas
 - (5) stores records are maintained by employees functionally independent of storekeepers
 - (6) there are adequate controls to prevent theft or diversion of material. Unauthorized persons are denied access to storerooms. There are special safeguards for high dollar value material and material susceptible to personal use or sale
 - (7) materials are stored to facilitate locating, withdrawing, handling, and counting
 - (8) procedures provide for the timely reporting of slow moving, obsolete, and overstocked material, such as electronic, automotive and truck parts, or copper, brass,

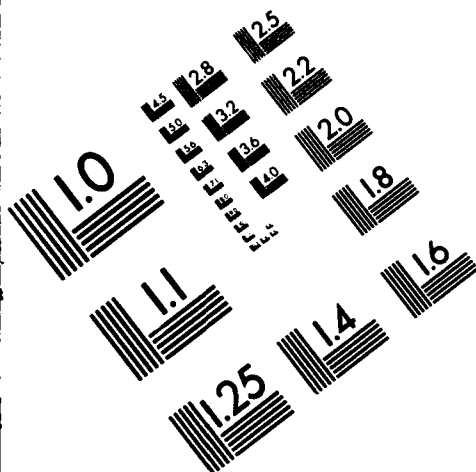
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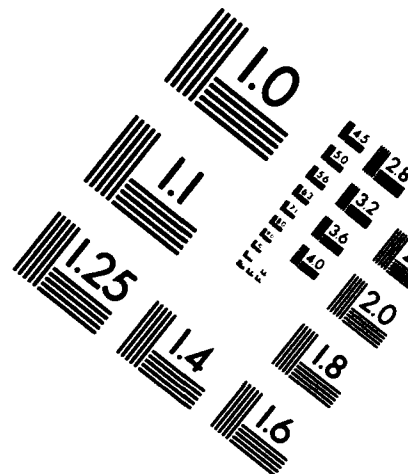
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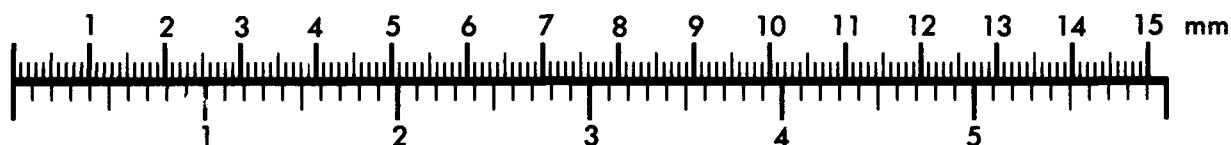
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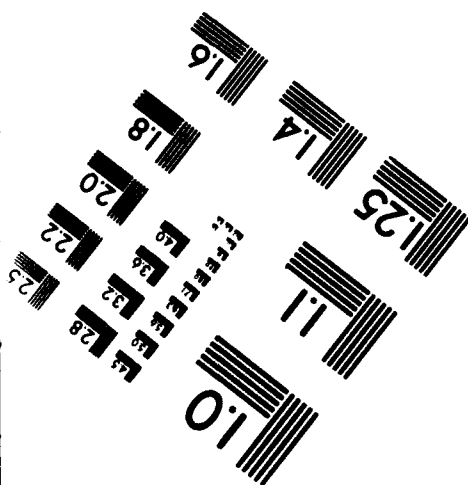
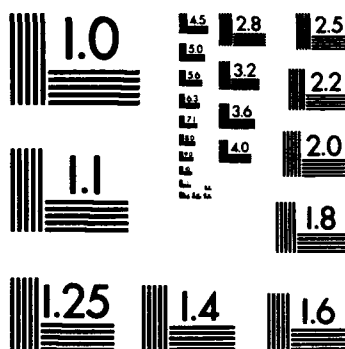
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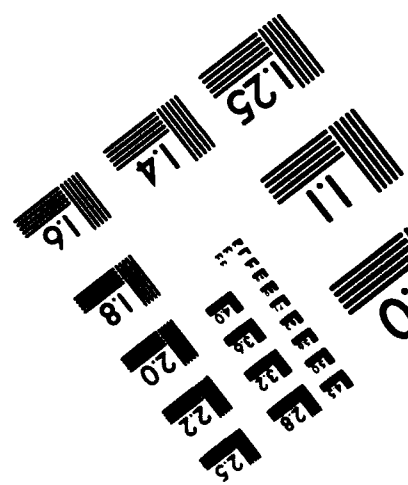
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- or other high value metals or components
- (9) procedures provide for the release of materials only upon the receipt of a properly approved requisition
 - (10) requisitions applicable to government-owned materials are distinguishable from requisitions for contractor-owned materials
 - (11) controls provide for proper charges and credits when material is transferred between/among contracts
 - (12) procedures provide that appropriate credits are issued when unused material is returned to stock, or where material is diverted to other work
 - (13) procedures are in effect to control the collection, segregation, and disposition of scrap and the issuance of appropriate credits (see 6-308)
 - (14) procedures are in effect which control and account for returnable items such as reels, containers, skids, boxes, and barrels
 - (15) procedures provide for issuing materials subject to spoilage or shrinkage on a first in first out basis
 - (16) the flow of accounting documentation is controlled by use of prenumbered forms, batch transmittals and/or other appropriate means

5-710.3 Inventory Accuracy

a. The contractor should have established procedures that prescribe how inventory record accuracy is verified as to quantity and location. Prior audits have found accuracy rates to be far below the recommended 95 percent level. A large number of material expeditors, substantial excess inventory, and frequent shortages of material to satisfy production needs can all be strong indicators that the formal system is not providing accurate information. Specific attention should be accorded the policies, practices, and procedures governing the classification, location, requisition, and responsibilities for contract inventory. Although not normally part of the testing of inventory accuracy,

the MMAS procedures should include requirements for shop floor accountability of materials in the production process.

b. For MMAS purposes, accuracy should not be determined based on the dollar value of an aggregate inventory. This technique is not representative of the physical accuracy of the inventory because the netting process and material planners rely on the accuracy of recorded inventory quantities when deciding to fill requirements and generate orders. A highly accurate inventory is necessary for the netting process to function reliably.

c. Inventory record accuracy attests to the accuracy of the on hand inventory as opposed to the physical (recorded count) inventory. Inventory record accuracy should be at or above 95 percent within preestablished tolerances (see (5), below). Inventory records used by the contractor to make decisions regarding the purchasing or fabrication of materials should be used when counting the on-hand inventory. An example of a formula for calculating inventory accuracy is:

$$\text{INVENTORY ACCURACY} = \frac{\# \text{ OF PARTS ACCURATE}}{\# \text{ OF PARTS COUNTED}} \times 100 = _ \%$$

d. An inventory classification system may be used by a contractor to focus available resources on controlling those materials posing the greatest risk. An example of this is the ABC inventory method. This system classifies inventory items in a decreasing order of annual dollar volume or other criteria. This array is then split into classes A, B, and C. Class A contains items with the highest annual dollar volume and receives the most attention. The medium class B receives less attention while class C, which contains low dollar items, has minimum controls. The principle behind the ABC method is that effort will be saved through relaxed controls on low value items that do not pose a significant risk. Effort can then be applied to reduce inventories and maintain stricter accountability of high value items.

e. The precision or degree of accuracy (tolerance) will vary by types of inventory. In the ABC inventory method, the acceptable tolerance for an item count of a particular part within a preestablished

5-710.3e.

range will vary depending on its A, B, or C classification. Tolerance is very similar in nature to precision as used in statistical sampling (i.e., +/- 5 percent). If a variable falls within a preestablished range, then results are considered acceptable. For inventory accuracy, the difference between recorded and physical in-

ventory is computed and compared to the preestablished acceptable tolerance. The more expensive items or items crucial to maintaining production have tighter tolerance ranges.

f. The following table depicts the test results for 10 parts within a particular classification.

Part No.	On-Hand Per Records	On-Hand Per Physical Count	Difference	Tolerance*	Accurate?
1	100	100	0	5	Yes
2	80	78	2	4	Yes
3	100	95	5	5	Yes
4	200	206	6	10	Yes
5	120	130	10	6	No
6	80	80	0	4	Yes
7	100	90	10	5	No
8	150	145	5	8	Yes
9	100	100	0	5	Yes
10	80	80	0	4	Yes

Number of parts accurate = 8
 Number of parts counted = 10
 Accuracy of this class = 80% (8/10)

* Assume acceptable class tolerance of 5 percent

g. Accuracy is based on counts within established tolerances. In the example above, the class tested has a preestablished tolerance of 5 percent. This means that for a recorded quantity of 100, units

physically counted during a cycle count must fall between 95 and 105 to be recorded as accurate. The following is an example of summarizing tests for inventory accuracy:

Class	(1) Parts Sampled	(2) Part Counts in Tolerance	Count Accuracy By Class*
A	50	50	100%
B	500	400	80%
C	1,000	950	95%
	<u>1,550</u>	<u>1,400</u>	90.3%

* Col (2)/Col (1)

h. Audit steps must include observations of contractor count procedures. Count procedures should ensure integrity of the process and include "blind counts."

5-710.4 Inventory Adjustments

The contractor should have established policies and procedures for making adjustments for the difference between booked and physical inventory counts, including the costing of such adjustments in the accounting records, if appropriate. The government has an interest in wheth-

er the contractor makes an adequate investigation of inventory adjustments and whether losses are acceptable as a reasonable cost on government contracts. Adjustments of losses and overrates and deterioration of inventory items may indicate inadequate inventory control and storage procedures. Adjustments of items that are surplus or obsolete may indicate the contractor is purchasing excessive quantities. The auditor should evaluate the contractor's policies and procedures to ensure that they provide for the proper investigation of inventory adjustments and follow-up to help reduce the need for future adjustments.

5-711 Material Transfers

MMAS Standard 6 (DFARS 252.242-7004(f)(6)). Standard 6 was established to assure that physical transfers of parts are based on valid reasons. Under normal circumstances, contractors are required to account for costs by contract. This standard recognizes that there may be times when it makes good business sense to transfer material from one contract to another with a more immediate need. However, prior audits have disclosed that in many instances transfers (physical, financial, or both) may occur with no apparent necessity. This standard requires the contractor to provide the government and users of the system descriptive reasons for transfer activity. In addition, the contractor should have controls in place to ensure that material transfers which are inconsistent with these reasons are identified, reported, and resolved on a timely basis.

5-712 Costing of Material Transactions

MMAS Standard 7 (DFARS 252.242-7004(f)(7)). This standard requires consistency in the methods used for costing material transactions. The costing methodology may be standard cost, actual cost, or any inventory costing method discussed in CAS 411-50(b). Consistency must be maintained across all contract and customer types and accounting periods. The contractor must maintain and

disclose a written policy describing transfer methodologies.

5-712.1 Costing Methodology

The contractor's system should clearly describe the methodology to be used in the costing of material transactions. The contractor may use standard or actual costs or any of the inventory costing methods in CAS 411-50(b). The auditor's review of the contractor's compliance with CAS 407 or CAS 411 should satisfy the requirements related to this area.

5-712.2 Sensitive Areas of Cost

The contractor's system should clearly describe how sensitive material transactions are to be costed. Sensitive transactions may be any material transactions identified by the government and contractor including areas such as interorganizational transfers (CAM 6-314); government furnished material/equipment (CAM 9-604.2); or special tooling and special test equipment (CAM 9-605.2). The auditor should identify all sensitive areas of material cost applicable to the contractor and related costing methodologies.

5-712.3 Costing of Transferred Parts

a. The MMAS system should transfer parts and associated costs within the same billing period. The billing period implied is a monthly accounting period.

b. For initial and subsequent transfer charging methods, the standard does not require contractors to use the same method for costing both an initial charge and a transfer charge. For any specific item, the value used for the transfer transaction may be different than the value(s) previously used to charge the item to inventory or to the contract from which it is being transferred. Transfers from one contract to another may be based on any CAS 411 valuation method. Selected valuation procedures must be documented, disclosed, and consistently applied to all subject transfers regardless of the nature of the final cost (government or commercial) or type of contract (cost reimbursable or fixed price).

c. When it is not appropriate to transfer parts and costs within the same period, a loan payback technique may be

used if approved by the ACO. A loan payback occurs when parts purchased or fabricated for one or more cost objectives are assigned or used on another cost objective without a corresponding transfer of cost. The need for a loan payback is typically caused by the borrowing contract's need for a particular part earlier than the loaning contract, which still has a need for the part. When this technique is used, the auditor should verify that controls are in place to ensure that parts are paid back expeditiously, corrections are made for any overbillings, the borrowing contract and loan date are identified, and the cost of the replacement part is charged to the borrowing contract.

d. Prior audits have disclosed conditions where (1) borrowed parts may not be paid back on a timely basis or are never paid back; (2) progress and/or final payments may be received by the contractor for the same parts on more than one cost objective resulting in over recovery of cost; (3) no audit trail exists providing visibility of the lending or borrowing contract or when the parts were borrowed and/or paid back; and (4) the borrowing contract may not be charged for the cost of the replacement parts.

e. The contractor should disclose written policies describing the transfer methodology used for manufactured parts. This would include parts that may be transferred at a sub-level, for which actual cost data is not accumulated. If the method provides a reasonable estimation of actual cost, it complies with the requirements of Standard 7.

5-713 Inventory Allocations

MMAS Standard 8 (DFARS 252.242-7004(f)(8)). When allocations from common inventory accounts are used, controls are needed in addition to the requirements of MMAS Standards 2 and 7. These controls will ensure that reallocations and any credit due are processed no less frequently than the routine billing cycle, inventories retained for requirements which are not under contract are not allocated to contracts, and algorithms are maintained based on valid and current data.

a. Common inventory represents those parts in inventory that are required for use on more than one cost objective. Prior audits have disclosed that allocations have not been based on valid time-phased requirements, or were not costed using consistent, equitable, or unbiased methodologies.

b. This standard addresses allocations of common inventory but requires that the contractor's system handle allocations in such a manner as to preclude improper costing.

c. Review the contractor's submission to determine the magnitude of contractor cost allocations from common inventories. If allocations are immaterial, further effort may not be required.

d. The auditor should determine that the classifications are appropriate for types of materials costed as common inventory. Common materials allocated must benefit contracts charged (when requirements exist). Allocations should not be too far in advance of required production dates without sufficient justification, such as availability of quantity discounts, economic order quantities, and known or expected vendor problems.

e. Assess the contractor's analysis of the common inventory being allocated to determine that the pool of common inventory allocated is accurate.

f. Evaluate the contractor's analysis and any tests that assure billings show common inventory costs were properly calculated (automated or manually) and costed on a current basis. Where common inventory is reallocated on a periodic basis, evaluate the contractor's analysis performed to determine the reasonableness of the basis and method for reallocation. Evaluate the contractor's evidence that shows the total adjustments (debits/credits) of reallocations are accurately reflected in billings.

5-714 Commingled Inventories

a. MMAS Standard 9 (DFARS 252.242-7004(f)(9)). This standard specifies that MMAS Standards 1 through 8 apply to commingled materials for which costs are charged or allocated to fixed price, cost-reimbursement, and commercial contracts. A contractor authorized to

use a multi-contract cost and material control system under FAR 45.505-3(f) is not exempted from meeting the requirements of MMAS Standards 1 through 8.

5-715 Internal Audits

a. MMAS Standard 10 (DFARS 252.242-7004(f)(10)). The MMAS system must be subjected to periodic internal audits to ensure compliance with established policies and procedures. This standard recognizes the contractor's commitment to self-governance and its contractual responsibility for systems and accounting internal controls. The contractor should be conducting on-going, self-initiated reviews of various aspects of its MMAS in a timely manner. Contractors may comply with this standard using in-house staff efforts or through the services of outside consultants.

b. Our interpretation of "internal audits" for purposes of compliance to this standard includes reviews performed by functional units as well as the internal audit staff. The auditor should be aware of the requirements of CAM 4-1000, Relying on the Work of Others. The level of objectivity and competence of personnel performing the reviews will have a significant impact on the reliability of the reviews and should be clearly communicated to the contractor. Both the auditor and the contractor should be aware that the objective is to ensure that adequate MMAS procedures and controls are in place and being followed, and that system adequacy is maintained on a real-time basis.

c. The auditor should ensure that the system is subjected to periodic internal audit. This standard does not create additional access requirements beyond those identified in FAR 52.215-2 and CAM 1-504. Consideration should be given to both the contractor's internal audit schedule of completed audits and audits performed by functional units that meet the objective of Standard 10. If the contractor contends that such reviews have been performed but is unwilling to make them available to DCAA in any form, the auditor may be unable to determine if the contractor has complied with the standard. The auditor should

evaluate the need for such access. Denial of access to relevant data should be escalated in accordance with CAM 1-504.

d. The contractor cannot comply to submission of an adequate demonstration if it does not provide to the government "sufficient evidence" of system compliance. If the internal auditor performs the self-assessment and demonstration, access to the detailed work products is a requirement in order to provide the necessary "sufficient evidence."

e. If a contractor is not performing periodic reviews of its MMAS, then it should be cited for noncompliance with standard 10. This should be cited as a serious internal control weakness in light of the complexity of MMAS and the risk of inaccurate costs being charged to contracts and included in "certified" billings. This control weakness should also be tied to cost impacts found during the audit and to FAR 32.503-6, Suspension or reduction of payments.

5-716 Reporting on the Results of Audit

a. The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems.

b. The auditor should formulate an opinion as to the contractor's compliance with the ten MMAS standards. Where deficiencies are disclosed, the auditor should quantify the impact. The auditor should keep in mind that, if required to demonstrate, the contractor is responsible for calculating a cost impact of system deficiencies and to take appropriate action to adjust contract costs or billings. The auditor should first analyze the contractor's cost impact and make appropriate adjustments. If the impact is considered significant, the auditor should recommend withholding appropriate amounts to protect the government's interest pending contractor corrective action.

c. The team leader should inform the contractor and the ACO of significant findings during the conduct of the evaluation. Although DCAA is a team mem-

ber, observation and recommendations will be forwarded via a separate internal control audit report (10-400) for incorporation in the team evaluation report. If the audit discloses significant deficiencies, the report will provide an estimate of the adverse impact on the government (the effect of deficiencies in procedures and/or controls). The report will also include a recommendation about the acceptability of the contractor's corrective action plan to the extent it is included in the contractor's response to our draft statements of conditions and recommendations. Until significant deficiencies are corrected, all field pricing reports for that contractor will contain a recommendation about proposed cost and pricing data adjustments necessary to protect the government's interest. Contract audit follow-up procedures under DoD 7640.2 (Section 15-600) apply to these reports. MMAS deficiencies should be identified as material accounting system deficiencies which are recorded in the permanent file Internal Control Audit Planning Summary (ICAPS) form (see 3-200) and the status of corrective action should be reported in the Contractor's Organization and Systems section of field pricing reports (10-411).

5-717 Disposition and Audit Follow-Up

a. On receipt of the MMAS report, the ACO will provide a copy to the contractor and allow 30 days, or a reasonable

extension, for a written response. If no significant deficiencies are identified, the ACO will notify the contractor in a timely manner.

b. When the ACO determines there is a significant MMAS deficiency, the ACO will act in accordance with FAR 32.503-6 to suspend an appropriate percentage of affected costs on progress payment claims and public vouchers. After acceptance of the corrective action plan, but before complete implementation, the ACO will reduce the suspension, as appropriate, to reflect the contractor's progress. However, total amounts of affected costs will not be approved for progress payments or public vouchers until the contractor's system is determined to be acceptable for government contracting or the amount of impact is determined to be immaterial.

c. The specific procedures for computing a cost impact will vary significantly based on the contractor's operations, conditions of the deficiencies, and compensating controls. The auditor should make every effort to quantify the effect of the specific deficiencies found during the audit. The auditor should:

- (1) develop an independent quantification of the identified deficiency
- (2) ensure that the methodology is representative of the specific conditions
- (3) ensure it provides a reasonable estimate of the harm to the government at the specific location

5-800 Section 8 — Compensation System Reviews (CSRs)**5-801 Introduction**

Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk. This section provides guidance for evaluating contractor compensation systems and related internal controls. The audit guidance described in the following paragraphs applies primarily to major contractors, but can also be adapted for use at non-major contractors where audit risk warrants a detailed review of the contractor's compensation system. Refer to CAM 6-413 for guidance on evaluating the reasonableness of compensation costs. Also, refer to CAM 6-414 for guidance on evaluating the reasonableness and allowability of compensation costs paid to owners, executives, and other employees who pose a higher risk of unreasonable compensation.

5-802 Background Information

a. Compensation for personal services is one of the largest components of cost incurred under government contracts. It includes all remuneration paid currently or accrued, in whatever form, and whether paid immediately or deferred, for services rendered by employees to contractors during contract performance. The objective of a contractor's compensation system should be to provide the level of pay necessary to attract, retain, and motivate employees to direct their efforts toward achieving the goals of the organization.

b. Sound compensation systems facilitate the attainment of this goal. It is, therefore, fundamental that contractors maintain compensation systems that consistently provide employee compensation costs that are reasonable, compliant with government laws and regulations, and subject to applicable financial control systems. To be considered sound, a contractor's compensation system must be reliable, consistently applied, and result in reasonable costs charged to govern-

ment contracts in accordance with FAR provisions.

c. FAR 42.302(a)(1) requires ACOs to review the contractors' compensation structures. The auditors' evaluations of these systems assist the ACOs in accomplishing this responsibility.

d. The cost principles pertaining to compensation are contained in Part 31 of the FAR. FAR 31.205-6(a) sets forth the basic criteria covering the allowability of compensation for personal services. To be allowable it: (1) must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages, (2) must be reasonable for the work performed, and (3) must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

5-802.1 Description of a Compensation System

a. A sound compensation system is considered an inherent part of establishing reasonable compensation. A system includes the organizational structure; established lines of authority, duties, and responsibilities; internal controls and managerial reviews; and internal and external consistency, pay structures, budgeting, merit and incentive pay programs, and benefits program. A contractor may establish one compensation system to administer the compensation programs for hourly, administrative, technical, professional, and executive employees or establish separate systems for each group. The guidance provided is generally applicable to each situation, but should be adapted to the circumstances of the review. The guidance is not applicable, however, to those compensation systems that govern employees covered by a labor-management agreement. See 6-413.1 for guidance pertaining to these systems.

b. When reviewing a contractor's compensation system, consideration should be given to the presence of characteristics

15-802.1b.

which are generally indicative of a sound system. A sound compensation system:

- (1) Requires periodic internal reviews of policy compliance, administrative process measures, adequacy of documentation, and reports to management on the results of reviews and recommendations for improvements; and requires corrective action plans to be developed, implemented, and tested.
- (2) Is soundly organized based on a definitive flow of authority.
- (3) Includes written policies and procedures that specifically set forth the design and operation of the job evaluation process, basis, and methods used to make pay decisions, and establishes supporting documentation requirements, authorization processes, and systems maintenance procedures.
- (4) Provides for sufficient training, experience, and skills to perform pay administration tasks in accordance with the contractor's established policies and procedures.

5-802.2 System Deficiencies

Conditions that may produce or lead to significant compensation system deficiencies are listed below. Significant compensation system deficiencies mean shortcomings in the compensation system internal controls which could result in or cause unreasonable compensation costs for the employee services rendered. These deficiencies are indicators that may suggest the need for further analysis or evaluation. They are not intended as a comprehensive checklist.

- a. Lack of established policies and procedures.
- b. Consistent absence of support for establishing and revising pay rates.
- c. Failure to establish and maintain formal criteria for incentive, merit, and bonus pay plans or to document the basis for awards made pursuant to the plans.
- d. Failure to establish and maintain wage and salary expense budgets to control rates and pay ranges.
- e. Lack of job descriptions that are complete, accurate, and updated on a periodic basis.

f. Other systemic internal control weaknesses such as inadequate authorizations, approvals, and documentation, that rendered the system inadequate or ineffective.

g. Failure to utilize appropriate wage and salary surveys when considering external equity.

h. Failure to audit compensation programs to ensure compliance.

i. Failure to comply with established policies and procedures.

5-803 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. It is DCAA's policy that CSRs are to be performed at least every three years at large business contractors which in their preceding fiscal year received at least \$50 million in government sales under negotiated prime contracts and subcontracts for which such sales represent at least 10 percent of total sales volume. These reviews may be waived or modified by the written approval of the regional audit manager if past experience and current audit risk is considered to be low. This determination of low risk must be fully documented. If audit risk is considered to be high, compensation system reviews should be performed more frequently. Most compensation reviews will be performed as separate assignments. At smaller contractor locations, selected compensation audit steps may be added to existing incurred cost or forward pricing audit programs. However, audit steps to review the contractor's compensation system are required before testing the reasonableness of compensation costs.

b. If possible, CSRs should precede indirect cost or forward pricing rate evaluations and major proposal actions.

c. Once a comprehensive review of a contractor's compensation system has been performed, it should serve as a baseline for establishing the scope of subsequent CSRs. Subsequent reviews would normally be limited to compensation system changes, compliance testing, and other areas identified as high risk.

5-803.1 Review of Executive Compensation

a. The contractor's executive compensation system should be evaluated separately, even if the contractor does not have a separate pay structure for executives. Policies and procedures for administering the compensation of executives should be evaluated using the guidance in 5-808 as appropriate to the circumstances. Some executives are also owners or in some other manner may directly influence their own compensation levels. See CAM 6-414 for criteria to use in evaluating compensation under those circumstances.

b. The contractor's policies covering executive compensation should include a definition of a top executive and how the top executive pay levels are established and approved. Generally, the list of contractor executives would include anyone with the title of vice president or above, and normally includes all individuals responsible for managing these primary functional areas: (1) executive office, (2) controller-accounting, (3) legal counsel, (4) engineering, (5) manufacturing, (6) purchasing, and (7) contracts.

c. Top executive positions are unique and must be reviewed individually. Position descriptions emphasize rank, function, responsibility areas, goals to be attained, impact of decisions, and number of employees directed. Divisional executives are distinct from corporate home office executives by their reporting level. Executives are not a class of employees. Overpayment of one cannot normally be offset against underpayment of another. However, in large organizations there may be a class of vice-presidents who have similar rank, function, and responsibility. In these cases, offsets may be appropriate.

d. Executives may be rewarded not only for their contribution to the organization, but also on the profitability of their functional unit as well as the overall profitability of the company. Pay packages include short- and long-term incentive pay as well as base pay, benefits, prerequisites, and services. Executive pay packages are normally set by the board of directors.

e. Evaluate the contractor's executive compensation system to include:

- (1) Evaluation of the compensation system as appropriate in 5-806 to 5-810.
- (2) Determination that the policies and procedures provide a description for how executive compensation levels are established and who approves these levels; and eligibility criteria and basis for determination of how base salary, cash bonuses, long-term prerequisites, benefits, services, and incentive pay bonuses are established.
- (3) Refer to 5-808.5b for guidance on the evaluation of the contractor's bonus plans and to 5-808.4 for general guidance on executive benefit plan evaluation.
- (4) Refer to 7-1907.8 for guidance on the evaluation of "golden parachute" benefits.
- (5) A comparison of executive pay (salaries, bonuses, and deferred compensation) for the current year in review to several past years for the purpose of establishing trends. The auditor should obtain the contractor's explanation and justification for significant increases. Also, consider the company's financial performance trends relative to the trends in executive compensation.

f. When making market comparisons of top executive pay (see 5-808.3), the executive compensation components being evaluated should be consistent with that shown in executive compensation survey data. Survey data most frequently includes base pay and cash bonuses combined and long-term incentive pay as a percentage of base pay.

g. Should the results of review of the contractor's executive compensation system determine that significant system deficiencies exist or the contractor has established pay policies or procedures that appear to promote unreasonable costs, conduct specific testing of the reasonableness of the executive compensation under FAR 31.205-6(b) as outlined in 6-413.2.

h. Often contractors will propose that their executives should be paid more than 110 percent of the reasonable com-

pensation based on the average compensation paid by comparable firms for executives with similar duties. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance which exceeds the particular industry's average.

(1) Examples of such financial performance measurements may include the following:

- Revenue Growth
- Net Income
- Return on Shareholder's Equity
- Return on Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

(2) The contractor must show that the measure chosen is representative of the executives performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard over which the executive has no influence and certainly there should be no extra compensation due to performance which results primarily from the contractor being a Government contractor.

(3) Use of a particular criterion to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measure reflected in the changes to compensation claimed as reasonable.

5-803.2 CAC/CHOA Network Coordination

a. The CAC/CHOA is to coordinate compensation audits at all major network components. The amount of coordination will depend on the degree of centralization of the contractor's compensation system and corporate office control over executive compensation. Do not program segment/division CSRs without giving consideration to these factors. When control over executive compensation is at the corporate office level, the DCAA corporate office auditor(s) should audit execu-

tive compensation. However, do not complete a segment/division CSR without obtaining input from the corporate office auditor(s) on segment/division executive compensation.

b. For compensation audits to be effective and completed on a timely basis, early and adequate CAC/CHOA coordination, planning, and audit initiation is required. Lack of coordination and planning can cause increased audit effort, inconsistency among network components, and invalid audit findings. Consistent treatment of wage increases, use of surveys, and audit approach to benchmarking and common employee classifications are some areas that must be coordinated. A CAC/CHOA network planning meeting may be necessary for this purpose. (See 15-200 for guidance on DCAA's CAC program.)

c. Establish each segment/division CSR within a CAC/CHOA network as a separate assignment. Follow this procedure even for network segments/divisions located within the same region regardless of the degree of centralization of the contractor's compensation system. Issue a separate audit report for each segment/division CSR performed and forward a copy to the CAC/CHOA. The CAC/CHOA may consolidate these reports into one overall report if all CSR issues from all segments/divisions are to be addressed at the corporate level by the corporate ACO (CACO).

5-803.3 ACO and PCO Coordination

a. Approximately 30 to 60 days before the scheduled starting date of a CSR, notify in writing the ACO and each government procurement office having a significant volume of business with the contractor that an audit will be performed. Request comments on any problems or special areas of interest relating to the contractor's compensation policies, procedures, and practices for consideration in the CSR.

b. Coordination with the ACO is essential throughout a compensation audit. Actively solicit ACO participation at the entrance and exit conferences, and keep the ACO informed of all significant audit developments. After completion of the field work but before the draft report is

released to the contractor, review all significant findings and recommendations with the ACO (see 5-810). Report disagreements with the ACO which cannot be resolved locally to the regional office.

5-803.4 Coordination with the Contractor

Inform the contractor of the upcoming CSR by sending a letter to the management executive responsible for the organizational unit to be audited. Describe the purpose and general scope of the audit, indicate the tentative starting date, identify the auditor in charge, and request the name of a contractor representative with whom audit matters can be coordinated. Identify specific data needed at the start of the audit (e.g., a list of all individuals who develop the compensation policy) and state the proposed date for an entrance conference. Also suggest the contractor present an orientation briefing on its compensation system, policies (including the process used to develop them), procedures, and other relevant data. Provide an information copy of this letter to the ACO.

5-804 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the compensation system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-805 Scope of the Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. In establishing the scope of audit effort, the auditor should carefully consider the nature and extent of documentation available from prior system reviews, related audit effort, and permanent files. Reliance on this information allows the auditor to better focus current review efforts on areas of greatest risk.

c. Additionally, contractor management has a responsibility to establish and maintain an effective internal control structure, including compensation system controls. As part of the preliminary audit effort, the contractor should be requested to disclose its compensation system, how the control objectives outlined below are accomplished, and what efforts have been made to evaluate the continued effectiveness of control procedures. The auditor should rely to the maximum extent possible on the contractor's self-assessment efforts (see CAM 4-1000, Reliance on the Work of Others).

d. The determination that the contractor has established and maintained a sound compensation system as set forth in the guidance should negate the necessity to test, or should reduce the number of tests for reasonableness of compensation paid pursuant to that system as provided under FAR 31.205-6(b) (see 6-413.2).

e. The evaluation of the compensation systems that govern compensation established in accordance with an arm's-length negotiated labor-management (union) agreement and the reasonableness of compensation costs resulting from such systems will be limited to the guidance in 6-413.1.

f. Many contractors have contracts which are subject to the Service Contract Act of 1965. This act requires contractors to pay minimum wages and fringe benefits in accordance with Department of Labor (DOL) wage determinations to employees performing on service contracts with the government. Covered employees do not include those employees in an executive, administrative, or professional capacity. If contractors subject to the Act are compensating employees in accordance with DOL determinations on prevailing wages in the area, no determination of the reasonableness of compensation should be made for these employees. Therefore, audit guidance contained in 6-413.2 is not applicable.

g. Other wage laws that require payment of prevailing wages as determined by DOL are the Davis-Bacon Act of 1931 and the Walsh-Healy Public Contracts Act of 1936. Accordingly, audit guidance contained in 6-413.2 does not apply to employees' wages covered by these laws.

h. Cost principles for educational institutions are contained in OMB Circular A-21. Refer to 13-406 for the general audit approach to educational institutions' compensation and 13-S10 for provisions on the determination of the reasonableness of costs in general and specific provisions pertaining to compensation costs.

5-806 Internal Audits of Compensation Systems

a. To ensure that its compensation programs are properly administered and maintained, a company should conduct periodic internal audits. The frequency of these internal audits will depend largely on the complexities of the system. This is an essential element of a sound compensation system and is a significant internal control measure.

b. Periodic internal audits should serve to assess the effectiveness of the pay administration system and the company policies to achieve specified pay objectives. In addition, they should also provide feedback to management by identifying problem areas for directing future development and design efforts.

c. The contractor should have policies and procedures relating to audits of the compensation system. These policies and procedures should outline who will perform the internal audit, what will be reviewed and under what circumstances the review will be performed.

d. A team or committee should be formed with experience in compensation to perform the periodic internal audit. At the conclusion of its review, this committee should provide management a detailed report of its review along with any recommendations. Management should review audit results and recommendations, prioritize the improvements that are required, allocate the necessary resources, and follow up to ensure that the work is completed.

e. Evaluate the contractor's system of periodic audits to determine that:

- (1) A system of periodic review is established.
- (2) Policies and procedures exist and are consistently followed that relate to the periodic review system.

(3) The contractor has qualified personnel that receive specific training or whose work experience is relevant to perform these periodic reviews.

(4) The frequency of the reviews (such as semiannual, annual, two-year cycle) is adequate.

(5) Recommendations from the review are implemented or other alternatives assessed within a reasonable period. Reasons for not implementing recommendations should be documented.

f. The scope of the audit to be performed on the contractor's compensation system should be adjusted to consider the extent that the contractor's internal review of the system can be relied upon. Refer to 4-1000, Relying on the Work of Others.

5-807 Review of Organization and Assignment of Responsibility

a. The compensation function may be organized differently by individual contractors because of the nature of their products and services, size and type of organization, degree of decentralization, management attitudes, capabilities of personnel, and other factors. Decentralization of the compensation function refers to a management strategy of giving separate organizational units the responsibility to design and administer their own systems. In contrast, a centralized system locates the design and administration responsibilities in a single corporate unit. Determine early in the audit the degree of centralization of the compensation function in order to adequately plan the audit scope when an organization with multiple operating units is involved. Refer to the guidance on CAC coordination on multiple unit audits in 5-803.2.

b. Another structure variation sets up the corporate compensation function as if it were an internal consultant with pay professionals required to market their pay programs and services to operating units. Normally, certain compensation plans such as health and medical plans, pensions, and corporate-wide profit sharing plans remain under the control of the corporate group. However, the responsi-

bilities for other compensation functions, such as job analysis, evaluation, surveys, and pay structure design, are delegated to the operating units.

c. The compensation function should be organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level. Each contractor should maintain a written description of the organization and duties of the personnel responsible for the design and administration of the compensation function.

d. Evaluation of the contractor's organization requires an analysis of the relationship of the organizational segments participating in the compensation function. For this purpose, the contractor should provide (1) organization charts, (2) written procedures or directives describing the organizational structure and responsibilities of the compensation design and administration group(s) and contributing departments, and (3) flow charts showing the work flow of the compensation system design and administration.

e. The evaluation should disclose whether:

- (1) Preparation of pay structures is effectively controlled either on a centralized or decentralized basis.
- (2) Lines of authority, duties, and responsibilities are clearly defined, including responsibilities for establishing, reviewing, and approving, pay range changes, starting pay rates, and pay increases.
- (3) Training is provided for employees involved in the pay design and administration process and benefits administration in the application of government regulations and laws and company compensation policies and procedures.
- (4) Selected pay professionals are trained, where appropriate, in the use of advance pay structure design and maintenance and administration techniques including appropriate documentation procedures.
- (5) Training modules are periodically reviewed and updated.

5-808 Review of Policies and Procedures

a. The compensation system of a company is of sufficient importance that direction and guidance for the implementation of the company's compensation objectives must be in a form that ensures complete understanding and precludes misinterpretation. As an internal control measure, a formal written statement of policies and procedures, rather than an informal one based on established customs of the company, is expected to exist at all contractor locations which received at least \$50 million in government sales under negotiated prime contracts and subcontracts and for which sales represent at least 10 percent of the contractor's total sales volume.

b. Policies are management's statements of principles for accomplishing the contractor's compensation objectives. These include (1) basic policies used by proprietor(s) or board(s) of directors to guide the course of business and to make the most effective use of resources including employee services, (2) supplemental and broad policies by top management to explain and carry out the board's basic compensation decisions, and (3) operational policies issued at lower management levels expanding the company's broad compensation policies as they apply to subordinate organizational elements.

c. Determine whether the contractor's compensation policies are (1) adequately documented, (2) consistent with prudent business practices, (3) adequate to provide sufficient control and accomplish management goals, (4) consistent with promulgated Cost Accounting Standards, government laws and regulations, and contractual requirements, (5) provide for periodic review and update, and (6) effectively implemented by adequate procedures.

d. Policies should cover such areas as (1) the lines of authority, (2) the design and operation of the job evaluation process, (3) the operation of performance appraisal procedures, pay structure adjustment procedures, pay decision objec-

tives for wage, salaries, merit and incentive pay and benefits, and budgeting.

e. Procedures should implement the contractor's compensation policies by prescribing directions for performing tasks and functions. Review the contractor's procedures to determine their acceptability. To be acceptable, a contractor's procedures should:

- (1) Be adequately documented.
- (2) Address both automated and manual portions of the compensation system(s).
- (3) Be consistent with disclosed or established compensation practices.
- (4) Be current, complete, and easily understood.
- (5) Provide for adequate records and evidence to evaluate the basis for pay decisions, including awards of bonuses or incentives, and to verify through transaction testing that the compensation system(s) are operating as desired.
- (6) Clearly define lines of authority, duties, and responsibilities for the administration of the compensation system.
- (7) Define responsibilities and documentation requirements for budget preparation.
- (8) Provide procedures for initiating requests for recruitment, dismissals, promotions, and pay increases, including criteria for approval of the request and required supporting detail.

5-808.1 Review of Wage and Salary Structures

a. A wage and salary structure provides management with a means to effect administrative and financial controls. It can provide a consistent basis for controlling and promoting the equity between internal and external factors (see 5-808.2 to 5-808.3). Some organizations place more emphasis on external equity, while other organizations place their emphasis on internal equity. The degree with which internal versus external equity is emphasized depends primarily on the organization and its structure.

b. If a contractor's wage and salary structure is the result of a significant

disparity between internal and external factors, the contractor should provide rationale for the disparity and the impact on the reasonableness of the compensation paid. For example, a contractor may evaluate auditors and accountants as equal in job worth with programmer/analysts but must pay the programmer/analysts significantly higher salaries than the auditors and accountants. The reason for the disparity is that there is a shortage of programmer/analysts and market competition demands higher average pay to attract and retain these employees. Disparities between external and internal equity may be long-term or short-term, moderate or severe. The contractor is expected to provide policies and procedures for the analysis and reporting of the disparities to management and plans for resolution of the disparity where appropriate.

c. A wage and salary structure is a hierarchy of pay grades/ranges established for jobs within an organization. A pay grade is defined as one of the levels or groups into which jobs of the same or similar value are grouped for compensation purposes. A pay grade should include all jobs having the same pay range: maximum, minimum, and midpoint. The key ingredients to the wage and salary structure are number of grades, grade midpoints, grade spread, grade overlap, and adjustments to the structure.

(1) Number of Grades. The number of grades depends primarily on the number of jobs evaluated, their hierarchical level in the organization, and their reporting relationships. A supervisor would not be in the same grade as his subordinates. The greater the number of layers of hierarchy an organization has, the greater number of grades it will require.

(2) Grade Midpoints. The distance between midpoints is largely determined by the number of grades. A midpoint most often is defined as the market "going rate" for jobs assigned to that grade. Midpoints actually will reflect the organization's policies regarding the relationship of their pay trend to the market (i.e., whether they lead, match, or lag behind the competitive pay rates).

(3) Grade Spreads. The grade spread is defined as the minimum and maximum

amount an organization is willing to pay for jobs within a given grade. Grade spreads are usually based on what other employers are doing, the size of benchmarked jobs identified in surveys, and some judgment about how the grades fit the organization. The grade spread, maximum over minimum, can vary from 10 to 100 percent. Top-level managerial positions tend to have spreads between 60 to 100 percent, mid-level managerial and professional positions tend to have spreads of 35 to 50 percent, and entry-level positions tend to have spreads of 10 to 25 percent. These range spreads will vary from organization to organization.

(4) **Grade Overlap.** Grade overlap is the degree by which one grade overlaps the adjacent grade. The differences in midpoints among grades and the grade spread determine the degree of overlap between adjoining ranges. A high degree of overlap and low midpoint differentials indicate small differences in the value of jobs in the adjoining grades. A low degree of overlap and high midpoint differentials indicate large differences in the value of jobs in the adjoining grades. As with grade spreads, there is no wrong or right grade overlap.

(5) **Adjustments to the Wage and Salary Structure.** From time to time, adjustments need to be made to the wage and salary structure. Reasons for changes include inflation and imbalances between external competitive pressures and internal equity. When an organization makes any changes to its wage and salary structure, the reasons for such change should be well-documented and consistent with related policies.

d. Evaluate the contractor's wage and salary structure to determine that:

- (1) There are written policies and procedures regarding the wage and salary structure and any changes or variations to it.
- (2) The contractor consistently implements the policies and procedures within the structure.
- (3) The contractor documents any changes to its wage and salary structure.
- (4) There is general consistency with pay grade and range assignments with job evaluation results.

- (5) The contractor's wage and salary structure was developed with consideration for internal and external equity.

5-808.2 Review of Internal Equity or Consistency

a. Internal equity refers to the pay relationships among jobs or skill levels within an organization. It is one of the basic compensation policies all employers must confront when managing employee compensation. It involves establishing and maintaining equal pay for jobs of equal worth and acceptable pay differentials for jobs of unequal worth. This is accomplished primarily through job analysis, job descriptions, job evaluations, and job structure. Every effective compensation system has a well defined system of internal equity. Without an effective system of internal equity, managers may give special and exceptional wage increases that result in inequitable pay for jobs of equal worth.

b. When establishing pay structures, organizations may place primary emphasis on internal or external considerations or a blend of the two, depending on the needs of the organization. Refer to 5-808.3 for a discussion of external equity considerations.

c. **Job Analysis.** Job analysis is a concept of collecting and analyzing data to be used in writing job descriptions. Recognizing similarities and differences among jobs is an important aspect of achieving internal equity. The basic premise underlying job analysis is that jobs are more likely to be described, differentiated, and valued fairly if accurate information about them is available. Job analysis procedures may be used to evaluate changing jobs and to establish new jobs.

(1) Some of the common methods of collecting data for job analysis include questionnaires, checklists, diaries, interviews, and direct observation. Typical data that are collected for job analysis fall in the following four categories:

<u>Job Content</u>	<u>Interpersonal Relationships</u>
Duties	Supervisor
Functions	Other Superiors

Tasks	Peers
Activities	Suppliers
Performance	Customers
Criteria	Union/Employee
Working	Group
Conditions	

<u>Work</u> <u>Characteristics</u>	<u>Worker</u> <u>Characteristics</u>
Risk or Exposure	Professional/
Constraints	Technical
Dependence/	Knowledge
Independence	Advanced Degrees
Time Pressure	Manual Skills
Conflicting	Verbal Skills
Demands	Written Skills
Pattern or Cycle	Managerial Skills
	Prior Experience

(2) The contractor's system of job analysis should include:

(a) An established method of collecting job data that is relevant to the particular job under review.

(b) Documented policies and procedures that describe the methods to be used and the data collected.

(c) Procedures to perform job analysis for established as well as new jobs.

(d) Periodic reviews of the system.

d. Job Descriptions. Job descriptions are the foundation of a sound compensation system. They have a variety of uses which include job evaluation, job pricing, classification control, performance appraisal, and third party defensibility. Job descriptions are used in the selection and placement of new hires and are vital to performance evaluation and merit ratings as a basis for relating employee performance to the descriptions and specifications for each job. Job descriptions are used to assist in the promotion or transfer of employees and provide a basis to assign tasks and to combine job functions.

(1) A job description should be current, accurate, and complete. The existence of current, accurate and complete job content based documentation such as job descriptions can enhance a contractor's ability to defend against unwarranted charges of discriminatory personnel practices and programs under such laws as the

Equal Pay Act of 1963 or Title VII of the Civil Rights Act of 1964.

(2) An evaluation of the contractor's job descriptions should determine that:

(a) Job descriptions include, at a minimum, a title, major duties and responsibilities, and specifications. However, the extent that job specifications, experience, and education required; skill levels needed; job knowledge required; supervision given; and working conditions and effort demands are listed depend upon the particular method of job evaluation which the contractor uses (refer to 5-808.2e). Job titles should be descriptive of job duties.

(b) Job descriptions are documented and approved.

(c) New job descriptions and revisions are subject to approval.

(3) The contractor should demonstrate that job descriptions are current, accurate, and complete and those used for benchmarking are valid. For those jobs that are administered under a maturity curve system (see 5-808.3d), job descriptions by design may be limited.

e. Job Evaluation. Job evaluation is a formal process by which management determines the relative value to be placed on jobs within the organization. It involves the systematic evaluation of the job descriptions that result from job analysis. The job evaluation process compares jobs within an organization, and assembles these jobs in a hierarchy based on their worth which is a job structure. A formalized job evaluation system would be expected for most contractors with over 100 employees.

(1) There is an almost limitless variety of evaluation methods emphasizing job content, but virtually all of them are modifications or derivations of the five major job evaluation methods listed below.

(a) Ranking. Ranking is the fastest and simplest of the classic methods of job evaluation. Evaluators rank jobs in order of their overall worth or value to the organization. The job that the evaluators believe to be most valuable is placed first, the one that they perceive as being worth least is ranked last and so on. Minimal job specifications are needed to use this method. These include the educational

and knowledge or other qualities required to meet the demands of the job.

(b) Classification. A number of grades or levels are specified beforehand, and broad descriptions are written to delineate the characteristics of the jobs to be placed in each of the grades. Each job is then evaluated by comparing the job documentation to the grade description, and the job is assigned to the grade that most closely describes the job characteristics.

(c) Slotting. Slotting is similar to the classification procedure. The evaluator compares new job descriptions with jobs already in the structure, and slots each job into the grade assigned to jobs of similar overall worth. A matrix is often used, with grades on the vertical axis and departments or job families on the horizontal axis, to facilitate comparisons across organizational lines.

(d) Factor Comparison. In factor comparison, key (benchmarked) jobs are identified. A series of distinct factors such as skill, effort, responsibility, working conditions, or subfactors thereof are selected and set forth in an evaluation manual. Each key job is ranked within each factor listed in the manual. A monetary or point value scale then is assigned to each factor and apportioned to every job ranked within a factor. Nonbenchmark jobs, or new jobs, are added to the system by finding the most appropriate monetary or point value within each factor. Totaling the points from each of the factors produces the final job rate. Job description specifications are derived from the job factors which are contained in the evaluation manuals.

(e) Point Factor. The point factor method is the most commonly employed job evaluation technique for exempt jobs. A number of factors are selected, such as those mentioned in factor comparison. These factors are weighted and a scale of point values is assigned to each to reflect this weighting. These factors are often set forth in an evaluation manual. Each job is compared to descriptions of the various levels or degrees within each factor. When the appropriate degree is selected for each factor, the assigned points are combined to produce a total score for each job. Job description specifications

are derived from the factors which are contained in the evaluation manuals.

(2) An evaluation of the contractor's job structure and job evaluation methods used for established or new jobs should determine that:

(a) There are written policies and procedures which describe the techniques and methods employed.

(b) There are qualified personnel possessing training and experience in job analysis to perform or supervise the evaluation process.

(c) There are updates to job evaluations on an as needed basis.

5-808.3 Review of External Equity or Competitiveness

a. External equity or competitiveness refers to the relationship of the contractor's pay levels relative to that of its labor and product market competitors. This is accomplished by obtaining external market data through pay survey data and comparing pay levels for common jobs (benchmark jobs). Management determines the extent to which external market considerations are used to monitor and influence its pay levels for the purposes of (i) ensuring that pay rates are sufficient to attract and retain employees and (ii) controlling labor costs so that the organization's product prices and services are competitive.

(1) Various factors influence external labor market competitiveness. These include (a) the extent of the demand for sought after skills and abilities, (b) the extent of the competition in product and service markets, and (c) internal factors such as ability to pay, business strategies, productivity, and experience of its work force. These factors act in concert to influence pay levels set during the design and administration of a compensation system, and therefore, would be considered by managers of pay systems when establishing the external competitiveness policy and determining procedures for putting the policy into practice.

(2) Since the external competitiveness policies and resulting pay levels have a profound consequence on the contractor's organizational objectives, the effect of a contractor's failure to adequately

consider these factors would constitute a significant system deficiency.

(3) The contractor formulates its external equity policies based on competitive labor and product market data (external pay surveys). Major decisions required include (a) determining the contractor's pay level policies and market definition, (b) determining the source of pay survey data, and (c) interpreting and applying survey results.

(4) The results of the evaluation of the contractor's external equity procedures should provide a basis for determining the necessity or the extent of an independent assessment of the contractor's compliance with FAR 31.205-6(b). Refer to 6-413.2.

(5) This guidance is not appropriate for the review of a nonunion pay structure for which wage increases are given in accordance with those paid to the contractor's union employees. Acceptance of these practices should be based upon the contractor's past practices and established policies followed consistently to pay these wages in accordance with that agreed to with its union.

b. Pay Policy. The contractor's pay policy defines its objectives for setting or revising wages and pay structures for establishing external equity. There are three classic pay level policies: to lead, match, or lag the marketplace. The rationale behind a lead policy is to maximize the ability to attract and retain quality employees. A pay policy to match the marketplace tries to ensure that a contractor's labor costs are about equal to those of its competitors. Setting a lag pay policy is to follow competitive market rates. Policies include the time period, position, or grade and the level at which the contractor decides to establish market comparability.

The contractor's pay policies should:

- (1) Include a description of how the contractor's pay levels relate to the market: lead, match, or lag.
- (2) Address what internal equity factors were considered and the time period established to achieve comparability with market (first day of the year, middle of the year, last day of the year).

(3) Address each pay structure (i.e. hourly, nonexempt, exempt, and executive), if the contractor has multiple pay structures with different pay policies.

(4) Identify the level (position or grade) at which the external equity is to be established.

(5) Identify the wage or salary rates at which the policy will be established (i.e., minimum, midpoint, or maximum of the pay grade).

(6) Identify which of the following the contractor is willing to pay for: job content, seniority, performance, skills, cost of living, or a combination thereof.

c. Relevant Market. Before the contractor can select an appropriate external pay survey(s), it must define its relevant market(s). Relevant labor markets are generally the contractor's product and employee competitors. Common factors that typically define relevant market include job or skill required, geographic area (distance employees are willing to commute or relocate), size of the company, organizational structure, technical sophistication, profitability, and industry.

(1) The contractor's selected key or benchmark jobs are the basis for defining its relevant labor markets. The primary relevant labor market for a job generally includes companies that the contractor competes with for similar skilled employees or the source of supply. This market consists of the geographic area(s) within which it would ordinarily expect to recruit all potential employees for a job and the geographic area(s) to which it would ordinarily expect to lose employees in that job. These geographic areas may be identical but need not be. This market can be defined within a geographic area, which consists of all or similar companies in the local, regional, national, or international market. Typically, the contractor would evaluate where it loses and finds employees to establish the initial basis of its relevant labor market.

(2) The relevant market will vary among each contractor and job group depending on pay objectives and the skills being evaluated. The relevant labor market will change depending on the job family being evaluated. For example,

exempt jobs (administrative, professional, and managerial) tend to compete on a regional or national basis. Whereas, non-exempt (clerical) and hourly (production) are most likely to compete in local and regional markets. However, generalizations of labor markets are not always correct. In large cities and metropolitan areas, high concentrations of engineers will translate into a regional labor market instead of a national market.

(3) Wages and benefits tend to vary according to the size of an organization. Accordingly, firms equal in size to the contractor should be included in the relevant market. Firms in the contractor's geographic markets that account for a substantial number of incumbents should be selected. The factor of size is most relevant in influencing pay for executives and to a lesser degree exempt and nonexempt.

(4) The factor of industry in defining the relevant market of a job relates to the company's competition in its product/service markets. This is important because of cost control and ability to pay considerations. Therefore, where possible companies of the same industry should be included in the relevant market as located in the same geographic area selected for the job. The factor of industry is most influential on the pay levels of exempt jobs. Where jobs are tied to a specific industry, as aerospace engineers are to the aerospace industry, the market for those jobs should be defined on an industry basis.

(5) Some other considerations in defining the relevant market for a job are compensation systems similarities, company performance (executive pay), supply of labor, and Equal Employment Opportunity (EEO) considerations.

(6) Evaluation of the contractor's procedures for defining the relevant labor markets should include:

(i) Adequacy of the contractor's rationale and evidential data supporting the relevant markets for its selected benchmark jobs. The contractor should provide a list of the companies perceived as its wage and benefit competitors for each wage structure such as hourly, clerical and administrative, managerial, scientific and engineering, and executives.

(ii) Propriety of the contractor's selection of participants in the pay surveys as to geographic area and type or size of industry. For instance, the selection of a geographic area beyond which a contractor realistically competes for hourly job employees could result in invalid or unrealistic pay decisions and unreasonable compensation costs.

d. External Pay Surveys. External pay surveys provide detailed data regarding market pay levels for specific jobs and are the primary tools used by the contractor to ensure compliance with its external equity pay policy. The pay survey data identifies rate ranges and a central tendency figure such as a mean, median, or mode salary/wage levels for each job. The contractor uses the pay survey data to recognize and evaluate pay trends in the marketplace, hiring and retaining competent employees, promoting worker productivity, developing an adequate and acceptable pay structure, and defending pay practices in a court of law. In addition, pay surveys can be conducted to prepare for labor negotiations, forecast markets and prepare budgets, make specific job pay recommendations, determine the hiring range for new jobs, study turnover, assess recruitment problems, give special pay adjustments, demonstrate relevance of economic decisions, signal dangerous pay situations, and maintain pay leadership.

(1) For jobs that require apparently similar work by a large number of employees, maturity curve pay surveys are often used to set pay levels by an employee's years since obtaining a scholastic degree such as a B.S., M.S., or Ph.D. degree. Although pay minimums and maximums are constructed around a mid-point value, this system does not recognize that there are differences in the value of work performed that do not relate directly to the number of years since an employee obtained a scholastic degree. The system makes no direct references to position responsibilities or specific assignments. It is often used as a cost-effective means of dealing with large numbers of employees with similar formal education performing similar work such as engineers in a research and development firm. Maturity curve sur-

veys may be used along with traditional job evaluation pay plans to provide a balance between the two methods.

(2) Maturity curves are based on the assumption that as a person gains more experience, the level of pay will also progress. Simply, a graph of maturity curves shows actual salaries of employees according to age group and profession using internal or external data. The contractor may use maturity-curve data to make comparisons between the salary of a scientist and other professionals in his or her age group within a department, among departments, within an organization, or outside an organization. Many contractors will use maturity curves to set salary increase budgets or to determine their position relative to the relevant labor market.

(3) The contractor should establish well-defined written policies and procedures detailing what criteria are used to select the pay surveys in evaluating its wages (i.e., geographical location, company size, type of industry).

There are three sources of pay surveys that the contractor may use for making market comparisons:

(a) Published surveys which are available for the general public to purchase regardless of participation in the survey.

(b) Private surveys based upon data from survey company clientele and which only participants may purchase.

(c) Contractor self-conducted surveys.

(4) Contractors generally use private surveys and self-conducted surveys. The contractor can tailor these surveys to represent its selected competitive market by including specific companies and jobs. Evaluate why certain companies were excluded from a survey as well as why certain ones were included.

(5) In most cases, no one survey is sufficient to determine the benchmark for all positions. Most companies use several surveys. A primary survey may be selected with secondary surveys used to corroborate the results of the primary survey. Request information on all surveys used by a contractor in benchmarking company jobs.

(6) Consider the basis for the contractor's reliance on a source of pay survey

data, including internal sources. Minimal information should include:

(a) The company name, society, or group that collected the data.

(b) The expertise in job evaluation and job analysis possessed by the individuals collecting the data.

(c) The names of the companies contributing data and the geographical location of the source data. The relation to and influence of these companies in the contractor's labor markets.

(d) The size of the sample of companies reporting data and the size of the companies reporting data for each job.

(e) The extent that the data is based on job titles and job descriptions.

(f) The number of years that the survey has existed.

(7) If internally developed pay surveys are used by the contractor, determine if the contractor independently ensures that they are unbiased and reliable.

(8) In addition, evaluation of the contractor's selected pay surveys should consider if:

(a) The survey provides specific job classifications with corresponding job content survey descriptions that identify duties, responsibilities, and experience. An acceptable alternative would be a maturity-curve survey because of difficulties encountered in evaluating professional, scientific, or engineering jobs.

(b) Well-defined written policies and procedures are established detailing what criteria are used to select the pay surveys in evaluating its wages (i.e., geographical location, company size, type of industry).

(c) The pay surveys provide the weighted average rates (going market rate or mean) by job. Also, the survey should provide sufficient range values, minimum and maximum rates, and/or percentile and quartile data to validate the average rate and changes to pay structures.

(9) Deficiencies in the contractor's selection and use of pay surveys include:

(a) Lack of job descriptions in pay surveys which cause the contractor to benchmark jobs based on position titles only. The use of job titles only in benchmarking does not ensure proper comparability of jobs.

(b) Lack of weighted average rate in the pay survey. Pay surveys may provide only the minimum, midpoint, and maximum pay ranges for each job classification. The midpoint of the range would not be reflective of the market rate because survey participants actually pay employees under the minimum and over the maximum.

(c) The contractor is unable to rationally support its basis for relying on the survey data used to make market comparisons.

(d) The pay survey the contractor uses is not representative of its labor market and there is no supporting data for the selection criteria.

(e) The contractor's compensation data were not excluded from the pay survey weighted average.

c. Market Comparison. Market comparison or job pricing is the process of comparing pay rates for jobs that reflect the best measure of what is being paid in the market. Pay surveys and benchmarked jobs are the primary tools used by the contractor to accomplish this task. Benchmarking is the process of matching the contractor's job to survey positions based on job content contained in the job descriptions. A specific match is called a benchmark. Generally, only key or benchmarked jobs are included in surveys. Benchmarked jobs are defined as reference points and can be characterized as follows:

- (1) Job contents are well-known and relatively stable.
 - (2) Supply and demand for these jobs is relatively stable and not subject to recent shifts.
 - (3) These jobs are representative of the pay grade under review.
 - (4) These jobs are large, incumbent jobs representing a significant dollar amount of base compensation.
- (a) The reason for benchmarking jobs is to establish reference points that assist in the development or adjustment of pay grades and pay structures.

(b) An adequate market comparison process:

(i) Documents the benchmarking analyses, which identify the established benchmarked jobs, pay survey(s) used

(primary and any secondary source), survey codes, and pay levels used.

(ii) Demonstrates the validity of benchmarked jobs to be appropriate job matches to the pay survey descriptions.

(iii) Establishes at least 40 percent of jobs assigned to a pay structure as benchmarked jobs, as appropriate.

(iv) Provides the basis of adjustments to the survey data such as escalation and lump-sum payments.

(v) Demonstrates how pay survey data is integrated with pay structure design and how benchmarking results are used in the formal budgeting process (see 5-1014).

5-808.4 Review of Employee Benefits Programs

a. Employee benefits consist of compensation other than pay for time worked. Common benefits include health and life insurance, pensions, worker's compensation, pay for time not worked, and others. The contractor's benefit structure should complement its wage and salary structure(s). Benefits tend to be provided by an organization rather than by job, except for executive perquisites and certain deferred income programs.

b. Although organizations compete over wage and salary levels more than benefit packages, it is still necessary for the contractor to consider the competitive labor market when establishing benefit levels. As an essential control measure for benefit costs, the contractor's policies should require the comparison of its absolute level of benefits to those of its labor and product competitors. The contractor may decide to lead, lag, or stay competitive. This requires the use of benefit survey data.

c. Benefit costs are allowable to the extent that they are reasonable and required by law, employer-employee agreement, or an established policy of the contractor under FAR 31.205-6(m).

d. The contractor's benefit policies should establish (1) the contractor's competitive objective in the overall value of the benefits package compared to that of other firms, (2) eligibility requirements for various benefits and the rationale for different probationary periods with dif-

ferent benefits, (3) the flexibility in plan coverage offered to employees ("cafeteria-style" plans or average employee plans), (4) the method of financing the benefit plans by either noncontributory, contributory, or employee financing.

e. As a means to control costs, the contractor should establish procedures to periodically conduct cost-benefit analyses of the company's benefit plans in total and of forecasts of future years' costs. These may be performed as adjuncts to the yearly budgeting process. The analyses should include determinations of the cost commitments for existing benefits programs and the costs of alternate or new benefits. If projected cost containment is prohibitive, then alternative financing such as employee contribution may be necessary.

5-808.5 Review of Merit Pay Programs

As a means of increasing organizational productivity and controlling compensation costs, the contractor may adopt pay for performance programs in place of, or supplemental to, general wage increases, cost of living allowances (COLA), and seniority increases. Pay for performance programs include incentive and awards directly linked to desired employee behavior, contributions, or results achieved. Merit pay programs measure and rate employee performance through the performance appraisal system.

5-808.6 Performance Appraisal System

a. The performance appraisal system provides the mechanism by which the job holder's contribution and work performance during a specific time period are identified and documented. A formal appraisal process promotes desired organizational goal attainment. Without a formal appraisal process, employees' achievements may not be directed to desired goals and the controls and feedback to the organization are unlikely. The performance appraisal system provides an organization with information used for (1) human resource planning, (2) identification of employee development and training needs, (3) compensation administration, and (4) validation of promotional selection procedures.

(1) Determine the adequacy of the contractor's methods and procedures for evaluating employee performance and the pay rewards given for acceptable achievement of prescribed goals.

(2) An adequate performance appraisal system should include:

(a) Policies that outline the kinds, format, and sufficiency of documentation required for each employee performance appraisal.

(b) Established evaluation periods and dates for completion of appraisal forms.

(c) Standardized appraisal formats for each system or type of appraisal system.

(d) Performance dimensions of a job to facilitate accurate and objective measurement of performance.

(e) An established rating scale with performance intervals such as unacceptable, acceptable, good, and superior performance and performance standards for each interval of performance.

(f) Required periodic training for all raters in the policies and procedures of the organization's appraisal system and in rating skills.

(g) Provisions for periodic program maintenance.

(h) Monitoring of performance appraisal ratings in appropriate groupings to evaluate training needs, provide feedback to managers and reports to senior management on the adequacy of the system and/or what needs improvement.

b. Performance-based pay plans include short- and long-term incentive pay plans and gain-sharing plans. Incentive pay plans establish a standard of accomplishment to which worker performance is compared to determine the level of increases. It can be a group or organizational goal. Incentive and gain-sharing plans involve three forms of payment: base pay, commission, and bonus. Review CAM 6-414 for applicable guidance regarding compensation for employees who pose a higher risk pursuant to FAR 31.205-6(b)(2).

(1) An adequate performance-based pay plan should include:

(a) Documented policies and procedures.

(b) Established methods of rate determination or standard performance measures and guidelines on the relationship

between the performance and the amount of award or incentive pay.

(c) The rules for eligibility for participation.

(d) An incentive fund based on a documented formula.

(e) Documentation requirements for the basis for the awards.

(f) Established timing of the performance evaluation and payment of award.

c. Allowability.

(1) Bonuses and incentive compensation are allowable as set forth in FAR 31.205-6(f),(i), and (k) provided that the basis of the award is adequately supported and the award is paid or accrued:

(a) According to an agreement established between the contractor and the employee before the services are rendered, or

(b) In conformity with an established plan or policy consistently followed, and

(2) Allowable costs limitations regarding stock bonuses (stock options and stock appreciation rights) are:

(a) The value of the stock equal to the fair market value on the measurement date, the first date that the number of shares awarded is known. If the stock option or stock appreciation price is equal to or greater than the market price on the measurement date, then no costs are allowed for contracting purposes.

(b) Phantom stock plans differ from stock option plans in that no stock is transferred to the employee and no cash outlays are required. Contingent stock shares are attributed to the employee. The employee's account may be increased by the equivalent dividends issued and any appreciation in the market price of the stock over the price of the stock on the measurement date. Such increases in the employee's account are unallowable.

c. Deferred Compensation Awards. The allowability of deferred compensation awards are subject to the provisions of FAR 31.205-6(k) as follows:

(1) Awards made in periods subsequent to the period when the work being remunerated was performed are not allowable. Therefore, a plan and the amount of award must be determined prior to the period of performance.

(2) The costs of deferred compensation accruals are subject to the provisions of CAS 415, Accounting for the Cost of Deferred Compensation.

5-809 Training

Pay administration employees should receive training on those aspects of the compensation system which impact their respective duties and responsibilities. Adequate training is an important factor in the effective implementation of any system. When reviewing the contractor's training activities, the auditor should evaluate whether or not the contractor has a formal plan for ensuring that pay administration employees are kept apprised of developments within the pay administration profession as well as changes in the contractor's compensation system.

5-810 Audit Findings for CSRs

5-810.1 Preliminary Findings

Discuss audit findings with the contractor during the audit to confirm factual accuracy. At the completion of the field work, summarize all tentative findings and conclusions and coordinate with the ACO. If the ACO does not support the audit position, immediately inform the regional office.

5-810.2 Exit Conference

a. After resolving any differences with the ACO, hold an exit conference in accordance with 4-304 to discuss the findings with the contractor. Include the contractor's reactions in the working papers and the report.

b. During these discussions, address the total variance between the cost of the compensation element challenged and that of the comparison point of the comparative survey data used to establish the unreasonable elements. However, only question costs to the extent they exceed the point of significance (10 percent) (see 6-413.4).

5-810.3 Corrective Action Plans

a. If the contractor concurs with the findings, request that it submit a specific

15-810.3a.

time-phased corrective action plan for reducing compensation costs to reasonable levels and correcting related system deficiencies. If the contractor disagrees with the findings, request that it provide documentation justifying the reasonableness of the compensation elements challenged. Send the contractor a letter summarizing the conference discussions and request either the time-phased corrective action plan or the justification documentation. Send the ACO an information copy of the letter.

b. Contractors are responsible for determining corrective action plans to resolve system deficiencies and unreasonable compensation levels. The contractor is in the best position to evaluate and implement action plans. Action plans are expected to correct system deficiencies and eliminate trends of unreasonable compensation within a reasonable period of time. However, contractors are expected to initiate corrective action as quickly as practicable. A contractor is normally expected to reduce starting salaries and delay within-grade increases almost immediately and to make major strides to bring compensation costs under control within 12 months. Auditors are expected to advise ACOs of the adequacy and timeliness of action plans proposed by the contractor to resolve system deficiencies and unreasonable compensation.

5-810.4 Major Compensation Plan Revisions

Challenge increased compensation costs resulting from major revisions to existing compensation plans introduced by the contractor if the contractor (1) has not notified the cognizant ACO of the changes either before their implementation or within a reasonable period after their implementation and (2) has not provided the government, either before implementation or within a reasonable period after it, an opportunity to evaluate the reasonableness of the changes. See FAR 31.205-6(a)(4) and 31.205-6(b)(2)(ii).

5-810.5 Major Redeterminable Contracts

For major redeterminable contracts, consider recommending in price proposal reports that a ceiling be placed on labor

escalation and fringe benefit costs. Another approach is for the ACO to enter into an advance agreement with a contractor limiting labor escalation and fringe benefit costs on all contracts.

5-811 CSR Audit Reports**5-811.1 General Reporting Considerations**

a. After each compensation audit, issue an audit report to the ACO following the general guidance set forth in 5-100 and 10-400, as amplified below. If related audits or reviews by any other organization have recently taken place, incorporate the results into the compensation audit report, if feasible. Auditors should follow the guidance in 4-1000 when relying upon the work of others.

b. Because FAR 31.205-6 addresses some compensation elements only in general terms of their reasonableness and others in specific terms of allowability along with general reasonableness, the specific subsections referenced in the opinion paragraph should relate to the scope of the review.

c. The purpose paragraph should accurately describe the systems reviewed. If the contractor has more than one compensation system or pay structure, the purpose paragraph should identify which systems or structures are the subject of the review. All subsequent paragraphs should address each of the systems reviewed. If one system has a deficiency not shared by others, that deficiency should be separately identified to the particular system or pay structure.

d. Each CSR serves as the starting point for the next CSR for the same compensation system or pay structure, and establishes the basis for monetizing the findings of the next CSR. It is therefore critical for system control deficiencies to be reported even if the current CSR does not disclose that those control weaknesses are causing unreasonable costs.

e. For compensation paid to top executives, owners, and other high risk employees (see CAM 6-414), it may be appropriate to restrict the CSR scope and reporting of results solely to testing the

reasonableness of compensation paid or proposed for those individuals. Such an audit would specifically exclude an opinion on the adequacy of any systems in relation to the high risk compensation if there is not adequate control within the system to assure that it is consistently applied to such employees.

5-811.2 Reporting on CSR Summary of Audit Results

a. If the contractor's compensation system is determined generally sound, the following statement would be appropriate in the summary of audit results:

In our opinion, the contractor's compensation system is adequate to consistently provide reasonable employee compensation costs to government contracts per FAR 31.205-6 (a) and (b).

This paragraph should be appropriately modified if some compensation sub-systems or pay structures are not subject to adequate control to ensure that the compensation produced will continue to be reasonable in the future.

b. If the CSR determines that:

(1) some systems or pay structures within the contractors compensation system are deficient,

or

(2) some positions or individuals have inadequate internal controls over their compensation to assure consistently reasonable compensation,

then, the control deficiencies will be reported even if the CSR does not find unreasonable costs caused by those deficiencies. This reporting will establish that the government has noted the potential problem and reserves the option to question any unreasonable costs caused by those deficiencies in the future.

c. If unreasonable compensation is found, the summary of audit results section of the audit report may state:

In our opinion, under the contractor's current compensation system, cost avoidance in the amount of \$1.6 million, of which \$1 million is allocable to government programs, was determined for pay grades identified in

[applicable appendix or audit report section]. These costs were determined to be unreasonable under FAR 31.205-6(b).

d. This statement should be followed by briefly describing the condition(s) or system deficiencies that resulted in the unreasonable findings and how the correction of the deficiencies could result in cost avoidance per 10-400.

e. When unreasonable costs are identified in the audit report, the following should be included:

- (1) A listing of the contractor's pay grades and jobs or executive job for which compensation levels are unreasonable.
- (2) An estimate of the unreasonable compensation costs for each pay grade.
- (3) The methodology used and basis for determining that compensation costs are unreasonable and how all of the relevant factors were considered.
- (4) A description of the surveys used for making the FAR comparison tests.
- (5) The contractor's response to the audit findings (and, if appropriate, the auditor's rebuttal).
- (6) A copy of the contractor's proposed corrective action plan along with auditor comments on its adequacy and timeliness.
- (7) A recommendation that the ACO put the contractor on notice of the government's intent to disallow unreasonable compensation costs if the contractor fails to take timely corrective action. Such a notice by the ACO should identify the first period during which it would be feasible for the contractor to make significant changes to its system. The notice should also state that starting with that period unreasonable compensation costs, both actual and projected, will be questioned and that if the ACO issues a notice of intent, we will question all unreasonable compensation costs, actually incurred or proposed, for periods subsequent to the aforementioned date(s).

f. Audit reports issued on price proposals and rate agreements will question all unreasonable compensation costs proposed for periods subsequent to the date for completion of corrective action.

5-811.3 CSR Reporting Considerations for Fringe Benefits

All audit reports will contain the following qualifications relating to fringe benefits:

a. Scope: Modify this paragraph to refer to paragraph 2, "Circumstances Affecting the Audit."

b. Circumstances Affecting the Audit: Include within this paragraph a statement to the effect that the results of audit expressed in this report are qualified to the extent that subsequent audits or reviews by DCAA, the contract administration office, or others, of insurance, pension, and other fringe benefits may supplement the findings of this audit. When aware that specific audits or reviews are already in process or planned, state this information and identify the specific areas to be covered. In addition, determine if a recent DCAA or DCMC insurance and pension audit or review has taken place. If so, incorporate the results, if feasible, into the compensation system audit report. If incorporated, state this fact and reference the specific DCAA or DCMC report number and date. (See 5-1303 for guidance on insurance/pension reviews.)

c. Summary of Audit Results: Always qualify this paragraph by referring to paragraph 2, "Circumstances Affecting the Audit."

d. If, after giving consideration to offsets, fringe benefits in total and by individual element are within the range of reasonableness, include the following statement in the "Summary of Audit Results" paragraph:

"Our audit disclosed no employee benefit costs considered unreasonable under FAR 31.205-6 (a) and (b)."

e. If a contractor cannot justify employee benefit costs that significantly exceed the average of the comparison data by more than 10 percent (after giving consideration to appropriate off-

sets), include the following information in the report:

- (1) A statement in the summary of audit results paragraph that our audit disclosed that compensation costs for employee benefits are unreasonable under FAR 31.205-6 (a) and (b).
- (2) A recommendation (in the summary of audit results paragraph) that the ACO issue the contractor a written notice of the government's intent to disallow future unreasonable benefit costs.
- (3) A listing of each unreasonable employee benefit element, identifying the unreasonable costs for each, and a listing of unreasonable incurred employee benefit costs questioned per FAR 31.205-6(a)(4) and 31.205-6(b)(2)(ii).
- (4) A summary or copy of the supporting documentation or action plan provided by the contractor.

5-811.4 Follow-up Procedures for CSR Report Findings

When a CSR results in findings, recommendations, and costs questioned or qualified of \$100,000 or more, follow the procedures in DoD Directive 7640.2, "Policy for Follow-up on Contract Audit Reports." to report the findings to DoD components (see 15-600).

5-811.5 Dispositioning CSR Report Findings

a. Unreasonable compensation is not questioned for periods prior to a date established for completion of corrective action when unreasonable compensation costs are found during a compensation system review and a prior CSR:

- (1) Reviewed the compensation system as it is currently;
- (2) Determined that the compensation system reviewed was acceptable at the time of the prior review; and,
- (3) Determined that the costs produced by that system were acceptable at the time of the previous CSR.

However, cost avoidance estimated for a twelve month period after the date of expected completion of corrective action is recorded. Forward pricing rates for

periods after expected corrective action should also be adjusted. [Refer to 9-308, Incorporating Cost Avoidance Recommendations Into Price Proposal Reviews, and 9-1200, Forward Pricing Agreements, for further guidance.]

b. If prior CSRs identified unreasonable compensation and the Contracting Officer (CO) issued a Notice of Intent to Disallow Costs (FAR 42.801), then all compensation costs that are unreasonable after the allowed period for implementing corrective action should be questioned in forward pricing reviews, proposals, and incurred cost audits. If the CO has not made a final determination on the unreasonable costs in a CSR, continue to question any unreasonable compensation until a final determination is made. If a CSR report discloses unreasonable compensation and the CO disposes the audit report without supporting the unreasonable compensation, sub-

sequent unreasonable compensation should not be questioned.

c. Costs should be questioned for all periods of incurred costs and forward pricing if the unreasonable costs are produced by:

- (1) Failure to adhere to the previously reviewed system;
- (2) Changes to compensation systems previously reviewed if the changes have not been reviewed; or,
- (3) Pay structures or portions of systems previously reviewed which were found to be unacceptable or lacking controls at the time of the previous CSR.

d. Some contractors will have some pay structures, usually for executives or owners, which should be questioned for all periods if the compensation is found to be unreasonable. See CAM 6-414 for additional information on special considerations of executives and owners.

5-900 Reviewing Labor System Internal Controls

5-901 Introduction

a. This section provides guidance for reviewing contractor labor internal controls to evaluate the adequacy of the contractor's labor system and assess control risk related to the allowability and allocability of labor costs charged to government contracts. The reasonableness of labor costs is addressed in 5-800 (compensation system reviews), 6-412 (Evaluation of Quantitative and Qualitative Utilization of Labor) and 6-413 (Reasonableness of Compensation Costs).

b. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

5-902 Background Information

a. Labor costs are usually the most significant costs charged to government contracts, and usually comprise the base, or the largest element in the base, used for allocating indirect costs. Historical labor costs are often used to estimate labor for follow-on or similar item government contracts. Unlike other cost items, labor is not supported by third party documentation such as an invoice, purchase order, or receipt. Contractor personnel have complete control over the documents or devices of original entry, whether they consist of timecards, electronic media, or some other means. Responsibility for accuracy is diffused throughout the contractor's organization. Consequently, the risks associated with the accurate recording, distribution, and payment of labor are almost always significant.

b. To assess control risk on the labor accounting system as low and reduce substantive testing, the contractor's system should have:

- (1) An effective method to monitor the overall integrity of the labor/timekeeping system.
- (2) An effective employee awareness training program to reasonably as-

sure that all employees are aware of the importance of proper time charging.

- (3) Effective procedures for labor authorizations/ approvals to facilitate the proper accumulation and recording of labor costs to cost objectives.
- (4) Effective procedures for timekeeping to reasonably assure that labor hours are accurately recorded and that corrections to timekeeping records are documented, authorized, and approved.
- (5) Effective procedures for labor distribution to reasonably assure the proper recording of labor costs to cost objectives.
- (6) Effective procedures for labor cost accounting to reasonably assure that labor charges to the government are in compliance with promulgated Cost Accounting Standards, generally accepted accounting principles, and contract terms/clauses.
- (7) Effective procedures for payroll preparation and payment to reasonably assure independent preparation of the payroll, and that pay rates are appropriately authorized and accurate.
- (8) Effective procedures for labor transfers and adjustments to reasonably assure that they are documented and approved.

5-903 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. Once a detailed review of a contractor's entire labor accounting system has been performed, it should serve as a baseline for establishing the scope of subsequent labor system reviews. Subsequent reviews would normally be limited to periodic reviews of transactions and compliance based on the assessment of risk (e.g., floorchecks), labor accounting

system changes and other areas identified as high risk.

5-904 Audit Objectives

a. The purpose of the audit is to evaluate the adequacy of and the contractor's compliance with the labor accounting system's internal controls. The objective is to assess control risk for the allowability and allocability of labor costs charged and billed to government contracts.

b. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

5-905 Scope of the Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. Controls for interrelated audit concerns regarding the adequacy of the contractor's other major systems (e.g., EDP, estimating, etc.) will be audited under separate assignments. While the controls for these areas are not part of this audit, the results of all audits of these interrelated controls must be considered in forming an overall audit conclusion on the labor system internal control structure and also commented on in the related audit report.

c. In many instances, control procedures may be embedded in the contractor's EDP system. In these cases, the auditor should adequately document and test the automated portions of the system and give proper consideration to the use of Computer Assisted Audit Techniques (CAATs) (see 5-108f).

d. The extent of audit effort should also be influenced by:

- (1) the types of government contracts and their materiality
- (2) sensitive audit issues
- (3) deficiencies noted in ongoing audits (audit leads)
- (4) input from the contracting officer
- (5) contract provisions

These areas are discussed in 3-104 and the auditor should document the impact

of these considerations on the scope of this audit in the working papers.

e. The following paragraphs describe specific control procedures considered significant for an adequate labor accounting system.

5-906 Management Compliance Reviews

a. The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have policies and procedures for monitoring its labor accounting system, including regular compliance reviews to ensure the timely and accurate recording, distribution, and payment of labor costs. These policies and procedures should be well defined, reasonable in concept, and effectively implemented by contractor personnel.

b. As a minimum the contractor should conduct regular internal control compliance reviews. These compliance reviews should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom, and timely follow-up action on deficiencies.

(1) Types of Reviews. The contractor may perform internal compliance audits by monitoring in the form of physical observation (floorchecks), by testing labor charges for accuracy, by reviews of performance or exception reports, by requesting external audits, or by using a combination of techniques.

(2) Adequacy of Compliance Review Procedures. Whatever the form of the compliance reviews, there should be procedures which identify the intervals of performance of the reviews, the personnel responsible for performance of the reviews, the areas to be covered during the reviews, the specific steps to be performed in the reviews, the documentation needed to demonstrate the procedures have been performed, and the requirements for follow-up action.

(3) Overall Adequacy of Compliance Reviews. The adequacy of the compliance reviews should be assessed in accor-

dance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing the level of competence, independence, and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, or untimely follow-up actions.

5-907 Review of Employee Awareness Training

a. Policies and Procedures. The contractor should have policies and procedures for training employees to reasonably assure that all employees are aware of the importance of proper time charging. The training should cover indoctrination for new hires, management's responsibility for accuracy of labor accounting, refresher courses for existing employees, explanations of penalties for mischarging, and the importance of segregation of duties. When evaluating contractor policies and procedures for employee awareness training, the auditor should consider whether there is formal company-wide timekeeping and labor charging training, and whether there is documentation to verify that the training has occurred (e.g., presentation and handout material, sign-in logs, and memoranda of attendance.).

b. New Hire Training. New hires should be trained on proper time keeping shortly after being hired. The training should include proper timekeeping procedures and the penalties associated with the statutes on false claims and false statements (see 5-907.d). Further, those employees with contractual responsibilities should be made aware of the FAR, DFARS, CAS, and contract provisions. Specific responsibility should be placed on an individual or group to perform the training.

c. Management's Responsibility. It is critical to labor charging internal control systems that management continues to emphasize the employees independent

responsibility for accurately recording time charges. The contractor should have training programs stressing management's responsibility to provide for the accurate recording of labor hours.

d. Refresher Courses. The contractor should have periodic refresher courses on proper timekeeping and labor charging practices, as shown in 5-907.a. above, especially for employees found not to be complying with company labor charging procedures.

e. Penalties for Mischarging. Individual employees must be constantly, although unobtrusively, made aware of controls which act as an effective deterrent against violations. There should be an explanation of the penalties for knowingly mischarging time. This would include penalties imposed by the company and those by the government (i.e., False Claims Act). Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through posting of signs throughout the workplace, which remind employees of the importance of accurate and current timecards.

f. Segregation of Duties. The contractor should have training programs which stress the importance of maintaining a segregation of duties for labor-related activities to prevent the appearance of and opportunities for improprieties. For example, the responsibility for timekeeping and payroll accounting should be separated. In addition, supervisors who are accountable for meeting contract budgets should not have the opportunity to initiate or change employee time charges.

5-908 Review of Labor Authorizations/Approvals

The contractor should have procedures to facilitate the accumulation and recording of labor costs to cost objectives for the purpose of determining proper cost reimbursement on government contracts. These procedures should address the control and issuance of work authorizations, as well as the detail descriptions required for labor documentation. When evaluating the contractor's policies for labor authorizations/approvals, the auditor

should consider whether the policies and organizational structure provide for adequate control over work authorizations to assure the integrity of labor recording.

5-908.1 Control and Issuance of Work Authorizations

The contractor should have procedures to ensure the segregation of duties for work authorizations and/or job assignments, to the extent practical. The work authorizations/job assignments should be controlled and issued by individuals independent of those responsible for performing the work. A critical control is the procedure used to open and close work authorizations. These controls decrease the potential for circumventing cost targets or ceilings.

5-908.2 Work Descriptions

The contractor should have procedures for the preparation of labor documentation/work descriptions which require clear identification of the nature of the work performed. The work descriptions should provide enough detail to be trackable to the intermediate or final cost objective, and describe if the effort is allowable or unallowable/direct or indirect. Work descriptions should be sufficiently detailed to determine the allocability of the labor charges to government contracts.

5-909 Review of Timekeeping

The contractor should have procedures to assure that labor hours are accurately recorded and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals. When evaluating the contractor's timekeeping procedures, the auditor should consider whether the procedures are adequate to maintain the integrity of the timekeeping system.

5-909.1 Manual Timekeeping Systems

Procedures for manual timekeeping systems should provide for the accurate and complete recording of labor hours, as well as appropriate controls to ensure corrections to labor records are accurate and authorized. Generally, they may be

categorized as procedures which pertain to:

a. Supervisory observation of employee arrival and departure to prevent improper clock-in/clock-out.

b. Employee possession of timecard/timesheet.

c. Employees prepare their timecards in ink, as work is performed.

d. Only one card/sheet is prepared per employee per period; cards/sheets are preprinted with employee name and identification number; and cards/sheets are turned in to the designated timekeeping office or collected by an authorized person.

e. Precoded data is printed on the job cards for identification purposes.

f. Direct labor employees record their time no less often than daily. Sufficient formal subsidiary records are maintained, if necessary, to assure accurate time recording and allocating of labor costs to intermediate and final cost objectives when multiple jobs are worked in a day.

g. Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.

h. Employees and supervisors sign the timecards/ timesheets in accordance with procedures, certifying the accuracy of the recorded effort.

5-909.2 Automated Timekeeping Systems

Procedures for automated timekeeping systems should provide for the accurate and current recording of labor hours by authorized employees, as well as appropriate controls to ensure corrections to labor charges are accurate and authorized. Generally, they may be categorized as procedures which pertain to:

a. Only the employee uses their labor charging instrument to access the labor system.

b. Employee badge issuance is sufficiently controlled so that no number is duplicated and badges are not issued to unauthorized persons.

c. Procedures are in place which require the employee to report lost badges promptly.

d. Changes are initialled and dated by the employee and supervisor and include a description of the reason for the change.

e. A verifiable audit trail process is in place that collects all initial entries and subsequent changes.

5-910 Review of Labor Distribution

The contractor should have policies to reasonably assure the proper recording of labor costs to cost objectives. These policies should address the reconciliation of labor hours between labor distribution summaries and timekeeping/payroll systems, recording of both compensated and uncompensated hours worked, and maintenance of an audit trail.

5-910.1 Reconciliations

The contractor should have procedures which require that the total labor hours reflected in labor distribution summaries agrees with the total labor charges as entered into the timekeeping and payroll systems. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records. Each employee's time charge should be distributed as recorded.

5-910.2 Recording Hours Worked

The contractor should have procedures to ensure that all hours worked are recorded, whether they are paid or not, to assure the proper distribution of labor costs. This is necessary because labor rates and labor overhead costs can be affected by total hours worked, not just paid hours worked (also see 6-410).

5-910.3 Audit Trail

The contractor should have procedures which require the generation of an audit trail which documents distribution of direct and indirect labor charges to the appropriate cost objectives (e.g., a labor distribution report.). When evaluating the contractor's procedures, the auditor should consider whether direct and indirect labor charges are supported by sufficient evidential matter to verify the allocability to final cost objectives, and that

they are traceable to time cards and approved work authorizations.

5-911 Review of Labor Cost Accounting

The contractor should have procedures to reasonably assure that labor costs charged to the government are in compliance with promulgated Cost Accounting Standards, generally accepted accounting principles, and contract terms/clauses. The procedures should address concerns such as: sensitive labor accounts, briefing of contract terms, directly associated unallowable labor costs, lump-sum wages, overtime authorization, uncompensated overtime, and records retention.

5-911.1 Sensitive Labor Accounts

The contractor should have procedures to review significant increases and decreases in sensitive labor accounts for reasonableness and allocability. These procedures should also address changes in labor charging practices to assure consistency with CAS and FAR. Audit effort in this area may help satisfy MAAR 7 (changes in direct/indirect charging) and MAAR 8 (comparative analysis-sensitive labor accounts).

5-911.2 Briefing of Contract Terms

The contractor should have policies and procedures which address briefing of special contract terms and advance agreements relative to allowability and allocability of labor costs (See 3-200). The contractor should identify all contract terms with government costing implications such as military standards, overtime, and skill mix requirements, to ensure compliance with those terms.

5-911.3 Directly Associated Unallowable Labor Costs

The contractor should have procedures which require that direct and indirect labor costs directly associated with unallowable costs be identified and segregated. When reviewing the contractor's procedures for unallowable labor costs, the auditor should consider whether the chart of accounts and the contractor's disclosure statement adequately identify and describe the treatment of these costs.

5-911.4 Lump-Sum Wages

The contractor should have procedures to ensure that lump-sum wages resulting from union contracts are accounted for in accordance with EITFIS 88-23 (see 7-1919). The matching concept requires that lump-sum payments benefitting future periods should be deferred and amortized over the period benefitted (i.e., the period covered by the union contract).

5-911.5 Overtime Authorizations

The contractor should have procedures that address overtime authorization requirements prescribed by FAR 22.103. Such procedures, if applicable, ensure that:

- (1) overtime is necessary to meet delivery requirements,
- (2) overtime is necessary to meet performance requirements, or
- (3) overtime is necessary to make up for delays beyond the control or without the fault or negligence of the contractor (see 6-409 and 6-410).

5-911.6 Records Retention

The contractor should have policies and procedures which address retention of labor records to comply with current FAR requirements. These procedures should address the retention of labor records such as payroll records, labor distribution records, work authorizations, and timecards.

5-912 Review of Payroll Preparation and Payment

The contractor should have procedures to provide reasonable assurance that payrolls are prepared by persons independent of those responsible for the timekeeping operation and actual payroll payment, and pay rates and labor hours are appropriately authorized and accurate. (See 6-407).

5-912.1 Segregation of Duties

The contractor should have procedures to ensure that there is a segregation of responsibilities between timekeeping and payroll. These procedures are necessary

to reduce the opportunity for any person to be in a position to both perpetrate and conceal errors or irregularities such as fictitious employees, improper time charges, etc.

5-912.2 Accuracy of Labor Costs

The contractor should have policies and procedures which address the accuracy of the labor costs, particularly that pay rates in effect are supported by written authorization from the personnel department or other authorized source. When evaluating the contractor's policies, the auditor should also consider whether cross-checks are required (either manual or automated) for verifying the accuracy of names, rates of pay, hours worked, extensions, and accounting distributions. Labor hours used in the payroll process should be based on the labor distribution records.

5-913 Review of Labor Transfers and Adjustments

The contractor should have procedures to provide reasonable assurance that labor transfers or adjustments of the labor distribution are documented and approved. These procedures should address management review and approval of labor transfers, labor distribution edit errors, and review and correction of labor errors. Particular attention should be given to EDP assisted "on-line" adjustments. In these cases, controls should be in place to ensure that unauthorized or undocumented adjustments are prevented or detected in a timely manner.

5-913.1 Review and Approval of Labor Transfers

The contractor should have procedures which provide for a system of documenting, approving, and reviewing the transfer of labor costs from one cost objective to another by proper management officials. Written justification should be required for any such transfer, to ensure the proper allocation of labor costs to final cost objectives. Audit effort in this area may help satisfy MAAR 10 regarding labor adjusting entries/exception reports.

5-913.2**5-913.2 Labor Distribution Edit Errors**

The contractor should have procedures to ensure that labor distribution edit errors are processed into a suspense account and billed to customers only after correction.

5-913.3 Review and Correction of Labor Errors

The contractor should have procedures to ensure that reports of suspense labor and edit errors are generated and provid-

ed to the appropriate personnel for review and corrective action. These corrections should be adequately explained, and endorsed by both the employee and supervisor.

5-914 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1000 Indirect and Other Direct Cost System Review**5-1001 Introduction**

a. Refer to 5-101 for the auditor's fundamental requirements on obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

b. This section provides its guidance for reviewing a contractor's internal controls of both a manual and automated nature over indirect/other direct cost. The guidelines relate to the assessment of control risk based on a review of the contractor's policies, procedures, and internal control structure.

5-1002 Background Information

a. An indirect cost is any cost which is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or an intermediate cost objective (FAR 31.203(a)). Indirect costs are to be accumulated by logical groups and distributed on the basis of benefits accruing to the several cost objectives. The number and composition of cost groupings should be governed by practical considerations.

b. Other direct costs are costs which are in addition to direct labor and material and can be readily identified with a specific job. Examples are: (1) special tooling, dies, jigs, and fixtures; (2) plant rearrangement; (3) packaging and packing; (4) consultant's fees; (5) outbound freight; (6) expediting; (7) royalties; (8) travel; and (9) computer center and other service center costs. Costs of this nature may be charged direct to jobs, allocated on some representative basis, or charged partially direct and partially by allocation.

c. Generally, a contractor's indirect/other direct cost system should have:

- (1) Contractor compliance reviews to provide reasonable assurance that the policies and procedures relating to indirect/other direct cost submissions are established, currently in practice, understood, and effectively implemented by contractor employees.

- (2) Policies and procedures established and maintained to charge/allocate, directly or indirectly, allowable costs in billings, claims, or proposals applicable to U.S. Government contracts in accordance with FAR 31.2 and CAS.

- (3) Policies and procedures to ensure indirect/other direct costs are properly classified as allowable or unallowable in accordance with FAR and contract terms, including directly associated costs, and unallowable costs are identified and excluded from proposals, billings, and claims submitted to the government.

- (4) Policies and procedures to ensure indirect/other direct costs are properly charged/allocated to cost objectives in accordance with FAR and CAS.

5-1003 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. In the absence of indicators of widespread risk as documented by a current audit risk assessment, the need for a comprehensive review of a contractor's indirect/other direct cost system would normally be limited to certain situations. Such situations might include:

- (1) Contractor locations with significant government business where a detailed indirect/other direct cost system review has never been performed or has not been recently performed and where the auditor's knowledge of the indirect/other direct cost system is limited.

- (2) New government contractor locations where anticipated or actual government business is significant.

c. FAOs with audit cognizance over corporate and/or group offices allocating substantial costs to other segments for ultimate allocation to government contracts are responsible for performing indirect/other direct cost reviews at these

offices and providing the results to the segment auditor. Segment auditors are responsible for requesting such reviews as needed.

d. Once a comprehensive review of a contractor's entire indirect/other direct cost system has been performed, it should serve as a baseline for establishing the scope of subsequent indirect/other direct cost system reviews. Subsequent reviews would normally be limited to indirect/other direct cost system changes and other areas identified as high risk. Refer to 6-604.1, *Effect of Changed Conditions*, which addresses the risk for changes in procedures and practices for charging direct or indirect costs.

5-1004 Audit Objectives

The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the indirect and other direct cost system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems. The objectives of reviewing the indirect/other direct cost system are to:

a. Gain an understanding of the contractor's indirect/other direct cost system and related internal control structure to provide reasonable assurance that indirect/other direct cost in billings, claims, or proposals applicable to U.S. Government contracts are properly classified as allowable, allocable and reasonable in accordance with FAR 31.2 and CAS.

b. Document the understanding of the indirect/other direct cost system internal control structure in working papers and permanent files (see CAM 5-100).

c. Test the operational effectiveness of indirect/other direct cost system internal controls.

d. Assess control risk as a basis to identify factors relevant to the design of substantive tests.

e. Report on the understanding of the internal control structure, assessment of control risk and adequacy of the system for government contracts.

f. The discovery of fraud or other unlawful/improper activity is not the primary audit objective, but the auditor must be attentive to any condition which

suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

5-1005 Scope of Audit

a. The nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk. In general, the audit scope should be consistent with the guidance in 5-105.

b. In many instances, control procedures will be embedded in the contractor's EDP system. In these cases, the auditor should adequately document and test the automated portions of the system, and give proper consideration to the use of Computer Assisted Audit Techniques (CAATs).

c. The extent of audit effort should also be influenced by (1) the types of government contracts and their materiality, (2) deficiencies noted in ongoing audits (audit leads), (3) input from the contracting officer, (4) contract provisions, and (5) the degree of system automation, especially where new or existing EDP systems have been revised to better identify, extract, and record indirect and other direct costs. General information regarding these scope areas is provided in 3-104 and additional considerations specific to the indirect/other direct cost system are discussed below. A risk assessment documenting conclusions reached regarding the impact of the above areas on the scope of this review should be documented in the working papers.

d. Whenever practicable, expand the scope of audit for indirect costs to include other direct costs. The audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner.

5-1006 Compliance Reviews

Contractor compliance reviews should provide reasonable assurance that policies and procedures relating to indirect/other direct cost claims, billings, and proposals applicable to U.S. Government

contracts are established, currently in practice, understood, and effectively implemented by contractor employees. The existence of strong internal controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have written policies and procedures for monitoring its indirect/other direct cost systems, including regular compliance reviews.

5-1006.1 Internal Audit Function

The auditor should ascertain the effectiveness of the internal audit staff and consider the manner in which the internal audit function is utilized by management. Occasionally contractors use management teams in lieu of internal auditors to perform compliance reviews. The auditor should evaluate the competence, independence, and objectivity of the management teams. (Refer to 4-1000).

5-1006.2 Scope of Compliance Reviews

a. Adequacy of Procedures. The contractor's policies and procedures should provide for regular internal compliance reviews. These compliance reviews should address the following areas: (1) adequacy of written policies, procedures, and controls for indirect and other direct costs; (2) employee knowledge and compliance with policies and procedures; (3) composition of indirect cost pools and the bases over which they are allocated; (4) periodic sampling of expense accounts to ascertain if unallowable costs are properly identified and segregated; (5) periodic sampling to determine that when items ordinarily chargeable as indirect costs are charged to government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner; (6) consistency with which the policies and procedures are applied; and (7) treatment of miscellaneous income, credits, rebates, and discounts.

b. Adequacy of Reviews. The adequacy of the reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with the written procedures and by personnel possessing a level of competence, independence, and objectiv-

ity required of a reviewer. The scope and depth of audit should be consistent with the contractor's risk assessment level and sufficient to identify outdated written procedures, inconsistent application of the procedures, and lack of employees' knowledge or compliance with the written procedures. The auditor should consider and rely on, if appropriate, contractor internal audit control tests already performed. The auditor should: (1) identify and review the documentary evidence and the frequency of the internal and external reviews to determine whether the scope of such reviews are appropriate, the conclusions are sound, and appropriate follow-up actions recommended, and (2) determine if the methodology used to select sensitive accounts to be reviewed is consistent with the risk assessment level as documented by the contractor. If the contractor has volunteered for the indirect Contractor Risk Assessment Guide (CRAG) chapter, the policies regarding risk assessment and test methodology may have already been reviewed for adequacy.

5-1006.3 Follow-up Procedures

There should be policies and procedures for tracking responses to, and resolution of, required corrective actions. The policies and procedures should provide that corrective actions are communicated to management responsible for action, and that corrective actions are documented and verified.

5-1007 Trained Employees

A well trained staff results in accurate submissions to the Government. Contractor personnel should be aware of the certification requirements and potential penalties associated with submissions; therefore, they require special training in the preparation and submittal of billings, claims, and proposals.

a. Types of training. The contractor may provide internal courses or opportunities for personnel to take outside education courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures. In some instances, the contractor may require that personnel assigned to the preparation,

approval and/or review process have special qualifications prior to their being hired.

b. Adequacy of Procedures. Procedures should identify the minimum required course topics, the frequency of the training (periodic training should be given as needed, e.g. issuance of new and revised regulations, evidence of internal control weaknesses, etc.), and the criteria for documentation of completion. If specific procedures are not available, have the contractor identify its practice in the above areas for later verification with employees. The procedures should require that the training program be updated to cover current government rules and regulations, and adjusted to comply with revisions to the contractor's systems. These areas may be covered under more than one class, and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. The contractor should have policies and procedures requiring an employee awareness training program which informs employees of the special requirements that apply when a business contracts with the government. The training should include procedures for reporting and identifying false claims and the penalties associated with the statutes on false claims and false statements. Further, those employees with contractual responsibilities related to costs should be made aware of the FAR, DFARS, CAS, and applicable contract provisions. The contractor's procedures should provide instruction in claim preparation that provides for compliance with the following clauses: (1) FAR 52.216.7, Allowable Cost and Payment clause, which requires that the contractor submit a final indirect cost rate proposal reflecting actual cost experience during the covered period, together with supporting data (see DCAAP 7641.90 section on Incurred Cost Proposals for sample illustration of what is considered an adequate submission); and (2) DFARS 242.770 which requires that the submissions include a signed "Certificate of Indirect Costs." Policies and procedures should also require that employees be trained in contract briefing, reconciliations of claims to accounting records,

year-end adjustments of direct and indirect costs, and other related procedures.

d. The auditor should review the adequacy of the training policies and procedures to determine if they cover the appropriate topics, contain interpretation of the Government rules and regulations on the allowability of indirect/other direct costs, and that there are provisions to assure course materials are adjusted to comply with revisions to government rules and regulations. The contractor may have training records or attendance sheets that document employee training. If the contractor does not provide formal training, evaluate alternative procedures that ensure that employees and management involved in the approval process and/or preparation of indirect/direct costs submissions have the required knowledge. The auditor may consider making inquiries of employees who performed a procedure and inspecting documents and reports to ensure that employees are knowledgeable.

5-1008 Preparation of Indirect/Other Direct Costs Submissions

a. The contractor should establish and maintain written policies and procedures for preparing submissions (billings, claims, or proposals), applicable to U.S. Government contracts that include only allowable costs in accordance with FAR 31.2 and CAS.

b. The contractor's policies and procedures should require that claimed indirect/other direct costs be reconciled with actual costs as recorded in the books and records. Claimed costs may often be different from actual costs incurred; however, there should be a clear identification of all adjustments and an explanation that describes why such adjustments are necessary.

c. In addition, the contractor should have sufficient documentation for the auditor to assess the reasonableness of the contractor's interpretations of allowability. This documentation can be in the form of policies and procedures, desk instructions, preprinted forms, etc., and should provide enough detail for employees to determine the allowability of costs. Documentation supporting the allowabil-

ity of costs per advance agreements should also be provided. There should be documentation supporting the segregation and control of data rejections, corrections, and adjustments, e.g., year-end accruals, variances, and suspense accounts.

5-1009 Identification and Segregation of Unallowable Costs

Policies and procedures should provide for the identification and exclusion of unallowable costs from Government contract costs as required by FAR 31.201-6 and CAS 405.

a. Certain costs are rendered unallowable by provisions of pertinent laws and regulations. Examples of costs declared expressly unallowable by federal statute or regulations are: (1) contingent fees (except payments to bona fide representatives (FAR 31.205-7), (2) entertainment expenses (FAR 31.205-14), (3) fines and penalties (FAR 31.205-15), (4) costs of organizing or reorganizing a business enterprise (FAR 31.205-27), (5) contributions (31.205-8), (6) interest (FAR 31.205-20), (7) losses on other contracts (FAR 31.205-23), (8) certain types of advertising and business meetings (FAR 31.205-1), (9) bad debts (FAR 31.205-3), and (10) federal income taxes (FAR 31.205-41). A description of these and other items and the criteria for a determination of allowability are provided in FAR Part 31 (see Appendix A) and Chapter 7.

b. Other costs may be specifically identified in the contract as being unallowable. In these instances, the contract terms may also provide specific criteria that must be met before a cost is considered allowable, or there may be ceiling limitations on certain types of costs. For example, the contract may state that subcontracts or travel must be approved by the contracting officer prior to the incurrence of the cost, or it may state that overtime is unallowable over a specific dollar amount. Contract briefs should be prepared to identify these clauses.

c. Still other costs or portions of cost may be identified as unallowable based on advance agreements negotiated by the

ACO, such as IR&D and B&P Advance Agreements.

d. In addition, all costs which are directly associated with unallowable costs are also considered to be unallowable. For example, travel costs associated with an unallowable business activity (e.g., business reorganization) are also considered to be unallowable.

5-1009.1 Screening of Unallowable Costs

a. General Policies and Procedures. The contractor's accounting procedures should be in writing and should provide that indirect/other direct costs are properly classified as allowable or unallowable, including directly associated costs, and unallowable costs are identified and segregated for U.S. Government contract costing, billing, and pricing purposes as required by FAR 31.201-6 and/or CAS 405, if applicable. When evaluating the contractor's policies and procedures, the auditor should consider whether they:

- (1) Address all major duties and responsibilities in the indirect/other direct cost system. The procedures should be comprehensive and easily understood in order to minimize the risk of errors arising from causes such as misunderstood instructions, and mistakes in judgment. The procedures should require management/supervisory review and approval at appropriate control levels. Management review should be evidenced by the proper approval signature on the documentation and records in accordance with the contractor's policy. Electronic signature procedures should be implemented for automated cost records. There should be separation of key duties such as authorizing, processing, recording, and reviewing; and accountability over access to and use of assets and records. The auditor should be alert for aspects of the indirect/other direct cost system process which are not covered by policies and procedures. Additionally, the auditor should note any instances where actual practices are inconsistent with established policies and procedures. In these

instances, the auditor should consider the underlying cause for these inconsistencies (e.g., failure to adequately communicate changes in established policies and procedures). When testing the critical control points outlined in the procedures, the auditor should review evidence on adjustments as well as on regular transactions. If applicable, the auditor should compare relevant parts of the contractor's CAS disclosure statement to the policies and procedures.

- (2) Are approved by an appropriate level of management to signify the delegation of authority and to effectively convey management's commitment to adhering to established policies and procedures, and complying with FAR 31.2 and CAS.
- (3) Provide for the design and use of adequate documents and records. Records should be kept on all aspects of a procedure to ensure the proper recording of transactions. Records should also be classified in a way that permits easy access for audit trail (e.g., chart of accounts could be imbedded in the applicable systems internal edit schedules which segregates and identifies unallowable accounts at point of origin). Supporting documentation should be complete (i.e., include purpose), accurate (e.g. include credits if applicable), and readily available for examination. Various FAR clauses require specific documentation in order for allowability to be established. The contractor's procedures should provide for documentation that contracts have been briefed and expressly/mutually agreed to be unallowable costs, and directly associated costs have been identified and excluded.
- (4) Were communicated to those individuals within the organization who are responsible for executing them. This communication involves not only making sure that appropriate employees are aware of established policies and proce-

dures but providing the necessary training to ensure that they understand how to interpret and execute them. If the training for employees who approve, process, and screen costs is separate from that provided to employees who prepare cost submissions, follow the guidance in 5-1006.2.

b. Controls for Selected Sensitive Accounts. The following are examples of sensitive costs that warrant special consideration to comply with the regulations (refer to FAR 31.2 for complete list of sensitive areas and their requirements):

- (1) Entertainment costs. Procedures and controls should be established that distinguish entertainment costs, as defined in FAR 31.205-14, from allowable costs, such as public relations cost; travel cost; employee morale, health and welfare cost; and trade, business, technical and professional activity cost.
- (2) Independent Research and Development (IR&D) and Bid and Proposal (B&P) cost. Procedures and controls should be established which provide that IR&D and B&P are classified and allocated to U.S. Government contracts in accordance with FAR 31.205-18 and CAS 420. Specifically, procedures should require that:
 - (a) Each IR&D and B&P project should be separately identified if material in amount. When not material in amount, these costs may be accumulated in one or more project(s) within each of these two types of effort.

(b) The B&P projects should be described and identified, as appropriate, with a specific procurement objective and/or applicable request for proposal (RFP), request for quotation (RFQ), or invitation for bid (IFB).

(c) Effort such as production engineering, productivity improvement, industrial modernization incentives program (IMIP), etc. should not be confused with IR&D and/or B&P effort. Effort of this type and the related cost accounts should be described in sufficient

detail and specificity that distinguishes it from IR&D and B&P effort so as to preclude misclassification of these costs.

- (3) Legislative lobbying costs. Procedures and controls should be established to provide that all allowable and unallowable costs under FAR 31.205-22 are properly classified and documented.
- (4) Professional and consultant service costs should be supported as prescribed in FAR 31.205-33.
- (5) Relocation costs. Procedures and controls should be established to require that:

- (a) Payments be in accordance with an established policy or practice that is consistently followed.

- (b) Amounts claimed as allowable costs under government contracts be in accordance with the requirements stated in FAR 31.205-35.

- (6) Selling costs. Procedures and controls should be established which provide that selling costs are classified in accordance with FAR 31.205-38 and that:

- (a) Allowable direct selling and market planning costs should be separately identified from unallowable costs.

- (b) Allowable selling costs should be distinguished from B&P costs with respect to Government business.

- (c) The method selected and analysis used to allocate selling and marketing costs should be documented and in compliance with FAR and CAS, as appropriate.

- (d) Direct selling and market planning costs should be segregated by class of customer (i.e., U.S. Government, FMS/foreign sales of military products, and commercial). The method of segregation should be verifiable through documentation.

- (7) Travel costs. Procedures and controls should be established which provide that:

- (a) Allowable and unallowable travel costs in accordance with FAR 31.205-46 are appropriately

classified at some point between incurrence of the cost and the time when claimed as a contract cost.

- (b) Routines are in place to identify material amounts of unallowable labor activity based on the purpose of the travel.

- (c) Records required to substantiate and justify contractor-owned, leased, or chartered aircraft costs are maintained in accordance with FAR 31.205-46.

- (8) Trade, business, technical, and professional activity costs. Procedures and controls should be established which provide that an adequate description of the business purpose of meetings and conferences is either contained in or referenced in the reimbursement voucher.

c. Screening. Point of entry screening is inherently more effective than after-the-fact screening/scrubbing for the identification and segregation of unallowable costs. As a point of entry control, the contractor can use its chart of accounts to identify and segregate allowable and unallowable accounts (refer to the accounting system internal control structure). The contractor's failure to establish point of entry controls places an added risk on after-the-fact screening (refer to compliance reviews in 5-1006). Contractor follow-up on unclear or questionable costs can become ineffective with the passage of time. This added risk would translate into higher required confidence levels and precision than would otherwise be required, thereby impacting the nature and extent of audit effort. As a result of the required certification process, some contractors have incurred extraordinary costs for screening overhead costs prior to certifying their proposal. This extraordinary effort is often the result of the contractor's earlier negligence in establishing, maintaining, and/or implementing an adequate system of internal control, and may not be subject to reimbursement (see 7-1909.2). Deficiencies should be reported in accordance with 8-302.7 if they are noncompliances with CAS 405, or in accordance with FAR 31.201-6 if they are not CAS-related.

5-1010 Allocability Policies, Procedures, and Controls

Policies and procedures should assure that indirect and other direct costs are properly charged/allocated to cost objectives in accordance with FAR and CAS as appropriate.

a. The contractor's accounting procedures should ensure that items of the same nature as those charged as direct costs are not included in the indirect cost pools. The auditor should be alert to the possibility of inconsistencies in the treatment of direct and indirect costs, especially between cost reimbursable and other contracts or between government and other contracts. Such inconsistencies may result in inequitable charges to the government. For example, the auditor should ensure that costs charged to government work as direct costs are to be treated in the same manner on the contractor's other work, as required by FAR 31.202, FAR 31.203, and/or CAS 402. Therefore, the contractor should have policies and procedures for adequately describing and classifying costs as direct or indirect.

b. For CAS-covered contractors, such policies and procedures are a requirement of CAS 418.40(a). They should include provisions for justification and approval of changes in the direct or indirect classification of costs. Effective procedures will minimize the amount of testing needed. The extent of required testing may be further reduced by evidence of thorough contractor internal audit coverage of this area.

c. The contractor should have accounting policies and procedures which provide that all items of other direct costs are readily identifiable with the contract to which they have been charged. When an item is purchased, documents such as the purchase requisition, purchase order, receiving report, and inspection report should identify the contract for which the cost was incurred. When the contractor manufactures components or parts, the work orders and all documents serving as a basis for charges to the work order, such as requisitions and job tickets, should be identified with the contract.

d. Procedures should provide that indirect costs be accumulated by logical (homogeneous) cost groupings (pools), with due consideration of the reasons for incurring such costs, and allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pool costs to the final cost objective (FAR 31.203(b)). To satisfy MAAR No. 18, the auditor should determine that the allocation bases used by the contractor for the allocation of indirect costs are equitable and consistent with any applicable CAS requirements, generally accepted accounting principles, and applicable provisions of the contract.

(1) Procedures and controls should be established to provide that all costs (allowable and unallowable) properly includable in an indirect cost allocation base bear a pro rata share of indirect costs irrespective of their acceptance as government contract costs in accordance with FAR 31.203(c).

(2) Procedures and controls should be established to provide that expressly unallowable costs and costs mutually agreed to be unallowable are excluded from any indirect cost pool which is allocated to U.S. Government cost objectives. Directly associated costs should be handled in the same manner, unless the cost with which it is associated is included in the base over which the indirect cost pool is allocated. In such instances, the directly associated cost should remain in the indirect cost pool.

e. The auditor should determine if the contractor's policies and procedures require a thorough study of the indirect cost activity, including the activity bases used for allocation and the costs to be allocated, to determine whether the activity base chosen is appropriate for cost allocation and results in a reasonable measure of the activity. The base should: (1) be a reasonable measure of the activity, (2) be measurable without undue expense, and (3) except for the residual G&A expense, fluctuate concurrently with the activity which is the source of the costs.

f. Part IV of the contractor's disclosure statement provides information on the contractor's bases and pools, including a functional or departmental breakdown of

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indirect expenses. A review of the disclosure statement (or equivalent data from non-CAS-covered contractors) will frequently assist in determining whether cost allocations described in the policies and procedures are equitable. Any differences or inadequacies should be identified and reported to the ACO in accordance with 8-200.

5-1011 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200, and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1100 Section 5 — Review of Contractor's Billing System

5-1101 Introduction

a. This section provides guidance for reviewing contractor billing systems and related internal controls of both a manual and automated nature. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

b. Reviews of contractor billing systems addressed in this guidance relate to incurred cost reviews of interim and final public vouchers (6-1000), progress payments (14-200) and other incurred cost presentations (Terminations 12-000, FPI closings, interim cost reviews).

5-1102 Background Information

Billings on public vouchers, requests for progress payments, contract closing proposals, and related cost statements submitted by contractors do not normally reflect contract costs as recorded in the basic accounting records. Normal reconciling items include both timing differences and permanent differences and special controls and processes must be established to assure that these differences are properly removed from billings on public vouchers and progress payments. The contractor's billing system should include processes for:

a. Segregating and excluding unallowable costs as required by FAR, DFARS and/or contract terms.

b. Segregating incurred costs that must be paid before submission for reimbursement, or before inclusion in progress payment requests (e.g., unpaid material costs).

c. Withholding costs that are appropriate adjustments to the submission or request (e.g., costs in excess of ceilings, or liquidated progress payments).

d. Adjusting submissions for final rates or indirect billing rates that differ from the contractor current applied rates.

e. Identifying costs that require specific contracting officer approval (special purchases, overtime authorizations, etc.).

5-1103 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. Once a comprehensive review of a contractor's entire billing system has been performed, it should serve as a baseline for establishing the scope of subsequent billing system reviews. Subsequent reviews would normally be limited to billing system changes and other areas identified as high risk.

c. The auditor should be alert to changes in the contractor's EDP environment or changes in application software that may affect the billing system. A partial list of such changes includes:

- (1) automation of a manual billing system
- (2) automation of any billing system activities that were previously performed manually
- (3) changes in other systems (e.g., labor, material, indirect and ODC, etc.) that may affect the data files used by the billing system

5-1104 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the billing system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. The contractor billing system should provide reasonable assurance that billings applicable to government contracts are prepared in accordance with applicable laws and regulations, and contract terms; and that material misstatements are prevented, or detected and corrected in a timely manner.

5-1105 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk (materiality and sensitivity),

the audit scope should be consistent with the guidance in 5-105.

b. The auditor should review the contract mix to determine the materiality and sensitivity of certain aspects of the contractor's billing system (see 6-10S2)

(1) Identify those contract types which are sufficiently immaterial to justify substantive testing only and delete steps covering their unique billing controls. T&M and labor hours contracts generally require a unique set of billing controls because it is quite common for the contract to specify labor categories which do not coincide with the contractor established labor classifications. Similarly, due to security requirements, classified contracts may have a unique set of billing controls.

(2) Areas of emphasis may be determined by contract type. Cost reimbursement type contracts generally contain many more special contract provisions than FFP and FPI contracts; therefore more risk may be associated with the contract briefing systems when this type of contract is in the majority. The contractor may also use the billing system to provide incurred cost data for forward pricing proposals, FPI closings, and terminations. The other uses of the system may affect materiality considerations.

(3) Sensitive audit issues can have a significant impact on audit scope. For example, congressional interest in contractor overbillings would necessitate increased emphasis on contractor procedures to prevent overbilling on public vouchers or progress payments. The auditor should be alert to recognize and take appropriate action on matters of a sensitive nature.

(4) Other Related Systems—Billings are generally prepared from accounting records either manually or by computer applications. The major critical controls and system reviews related to the billing system are:

(a) Management's Philosophy and Operating Style. Review and briefly summarize the overall management philosophy and operating style based on information in the permanent file regarding the control environment. Determine whether management endorses the philosophy of written policies and procedures including

the currency and frequency of updates, advocates employee training and awareness, funds needed equipment and computer programming, encourages internal and external audits and develops performance controls.

(b) Accounting System and CAS Compliance Reviews (5-300 and 8-000). The contractor should have adequate controls to ensure costs recorded in the official cost accounting records used to bill costs are allowable, allocable and reasonable under FAR 31.2. (and CAS as appropriate)

(c) General EDP Systems (5-400). EDP systems should provide reliable data and the data should be properly secured.

(d) Budget and Planning System (5-500). Estimates of cost to complete contracts used for progress payment purposes should be current, accurate, complete, realistic, reasonable, and consider all relevant information.

(e) Material and ODC Systems (5-700 and 5-1000).

(i) Charges from material issued from contractor inventory for use on contracts should be identifiable on the billing record and supported by journal vouchers recording issuance of contractor-owned material; individual items of material should be traceable to the issue document; and, item pricing should conform to an acceptable practice and contractor established policy.

(ii) Billed material should be issued for current use on the contract and not merely issued to an intermediate holding area for the purpose of obtaining reimbursement. The contractor should not be purchasing material and charging it to common inventory (when it should be charged directly to the contract) to circumvent the actual payment requirement.

(f) Labor and ODC Systems (5-900 and 5-1000). Weekly and/or biweekly direct labor entries in the billing record should be based on the source documents for the journal vouchers distributing salaries and wages for the accounting period. Any labor adjustments appearing in the billing record should be supported by correction or reclassification journal vouchers. For T&M or labor hour contracts in the contractor labor distribution system, in-

curred labor hours should be input by contract category to the billing system, and the controls preventing misclassification of employees should be reviewed as a part of the labor controls.

(g) Indirect and ODC Systems (5-1000). The contractor should have controls to provide for developing, approving, and applying proper indirect expense rates in the billings (see 6-700).

(h) Financial Capability. The contractor should have controls to assess on a periodic basis if it has sufficient financial resources to complete its contracts.

(5) The auditor should consider the following possible audit leads in determining scope of the billing system audit:

- (a) billing system audit leads
- (b) outstanding internal control deficiencies in other relevant accounting systems
- (c) material misstatements found in incurred cost audits, i.e., public vouchers, progress payment requests, contract closing statements or other incurred cost reviews.

(6) Contractor's Organization—contract billings or portions of the billing information may be the responsibility of different sections of the contractor organization. For instance, because of their unique nature T&M or labor hour billings may have an entirely different process flow than cost type billings. The number of processes to be reviewed and the consistency of the processes will influence the scope of the review.

c. Assessing control risk—To assess control risk on the billing system as low and reduce substantive testing, the auditor should determine if the internal control policies and procedures in contractor's billing system accomplish the following control objectives by providing:

- (1) Effective methods of monitoring the billing system and performing management compliance reviews to assure that the companies policies and procedures are adequate and current, are disseminated to all appropriate personnel, and are implemented in a timely and consistent manner.
- (2) Adequate written billing system policies and procedures which address employee training, how to

determine billing requirements, billing approvals, reconciliations of billed cost to the cost accounting records, adjustments of direct and indirect costs to year-end actual allowable rates, exclusions of unpaid cost, that is not eligible for reimbursement until paid, estimates of costs attributed to items delivered/invoiced, adjustments of billings on potential loss contracts, title to assets whose costs are billed, and the development of estimates at completion.

- (3) Adequate and effective implementation plan for the billing system to assure that policies and procedures are executed including dissemination of policies and procedures to employees, training of employees and management review of billings.
- (4) Effective general EDP controls over data center operations and adequate physical and logical security over relevant systems like labor, material, and indirect and ODC.

d. The following paragraphs contain general guidance for the review and evaluation of the contractor's billing system. This guidance gives the auditor a framework for the audit, but it is not a substitute for professional judgment. The auditor should adapt this guidance to fit their individual circumstances.

5-1106 Management Compliance Reviews

Systems that rely on external controls only increase the risk of cost mischarging or misallocation. The existence of strong self-controls increases the reliance that can be placed on the cost representations from that system. Therefore, the contractor should have policies and procedures for monitoring its billing system, including regular compliance reviews. These compliance reviews should address the following areas: the adequacy of written procedures, employee knowledge and compliance with policies and procedures, consistency with which the policies and procedures are applied and by whom,

and timely corrective action on deficiencies.

a. **Types of Reviews.** The contractor may perform internal compliance audits using auditors or nonauditors, that involve physical observation, reviews of performance or exception reports, external audits, or use a combination of techniques. Because billing is generally performed in the accounts receivable area and this function is consistently audited by both internal and external auditors, some or all of the compliance reviews may be performed by them. The contractor may also have various performance criteria and reporting requirements to upper management which relate to incurred cost billings. For example, excessive numbers of vouchers returned by paying offices or excessive number of days to process vouchers, may indicate noncompliance with control procedures.

b. **Adequacy of Procedures.** Whatever the form of the reviews, there should be procedures which identify the intervals of performance of the reviews, the personnel responsible for performance of the reviews, the areas to be covered during the reviews, the documentation required to evidence the reviews have been performed and the requirements for follow-up action. The procedures should address coverage of the following areas:

- (1) review of the adequacy and consistency of application of the written procedures for the billing personnel
- (2) employee knowledge and compliance with these written procedures
- (3) responsiveness to required corrective actions.

In addition, procedures for inputting billing related data and procedures for the correction of erroneously entered data should be available.

c. **Adequacy of Reviews.** The adequacy of the reviews should be assessed in accordance with the criteria in 4-1000. The reviews should be performed in accordance with written procedures and by personnel possessing the level of competence, independence and objectivity required of a reviewer. The scope and depth of audit should be consistent with the contractor risk assessment level and sufficient to identify outdated written

procedures, inconsistent application of the procedures, lack of employee knowledge or compliance with the written procedures, or untimely corrective actions.

5-1107 Policies and Procedures

A formal written statement of policies and procedures rather than an informal one based on established customs of the organization should exist at all contractor locations with substantial government business. Therefore, the contractor should have adequate written policies and procedures, and training on the preparation and submission of billing requests in accordance with applicable regulations and contract provisions. Written policies and procedures help ensure that

- (1) directions for performing both automated and manual tasks are clearly defined
- (2) delegated duties and responsibilities are formally documented and communicated to employees
- (3) processes are performed consistently from billing to billing.

5-1107.1 Training of Employees

A well trained staff results in current and accurate billings to the government. Because of the unique requirements associated with government contracts, certain contractor certifications, and potential penalties associated with billings, contractor personnel need to be specially trained to prepare and submit government billing requests. Therefore, the contractor should assure that all appropriate personnel have training in the preparation and submission of billing requests.

a. **Types of Training.** The contractor may require that personnel assigned to the processing of government billings have special qualifications prior to their being hired. The contractor may provide opportunities for personnel to take outside educational courses or provide internal courses. The contractor may also provide detailed on-the-job training and/or detailed desk procedures.

b. **Adequacy of Procedures.** Procedures should identify the minimum required course topics, the frequency of the training and the criteria for documentation of

completion. If specific procedures are not available, have the contractor identify its practice in the above areas for later verification with employees. The procedures should require the training program be updated to cover current government rules and regulations and adjusted to comply with revisions to the contractor system. These areas may be covered under more than one class and some may be covered by memorandums, bulletins, or pamphlets.

c. Adequacy of Training Topics. Training programs may include:

- (1) an overview of the contractor's accounting system
- (2) information on specific billing procedures (automated or manual)
- (3) an overview of written policies and procedures
- (4) instructions on briefing contracts
- (5) a description on the review and approval process
- (6) information on penalties associated with the statutes on false claims and false statements acts
- (7) guidance on applicable FAR, DFARS, CAS and contract clauses
- (8) information on the contract close-out process.

EDP workstation procedures relative to billing system transaction activity should be covered as well as procedures for correcting erroneously entered billing data.

5-1107.2 Contract Briefings

Government contracts sometime have very unique documentation requirements, withhold criteria and cost exclusions associated with interim and final payment approvals. An effective billing system identifies these requirements and includes them in the process. Therefore, procedures and controls should be established to ensure that contracts are reviewed to identify all billing requirements and that these requirements are documented either in a contract brief and/or directly input into an automated system. Policies and procedures should address the following:

a. Identifying Requirements. Procedures should clearly identify the types of information required on the brief (see 3-200 for examples of requirements).

b. Compiling Data. Procedures should identify the process for briefing contracts. The contractor may have a form (automated or manual) with blanks for various types of contractual requirements, or check marks to indicate the inclusion of FAR, DFARS and other regulatory mandatory clauses. Training manuals may also provide a handy reference for briefing personnel.

c. Frequency of Briefs. Procedures should identify the frequency criteria for briefing contracts. As a minimum briefs should be updated as soon as modifications are received or prior to the start of the next billing interval.

d. Responsibility for Briefing. Procedures should identify those responsible for briefing contracts. Briefs are most often prepared by billing personnel but may be prepared by contracts or other personnel as long as there is appropriate segregation of duties and the personnel are trained.

e. Manner of Updating. To facilitate updating, verification, and review, the contractor may include the latest modification number on the billing. If an automated system is used, exception reports may identify contracts not briefed, or ones that have not been updated in excess of certain specified intervals. The billing system may not allow processing unless the briefing has been completed or approved. Manual systems may require attachment of the brief or modification to document auditor and/or supervisor review.

f. Method of Inputting. If applicable, the procedures should identify how the briefed requirements will be included in the billing.

5-1107.3 Management Review and Approval

The contractor should have procedures which require supervisory or management review and approval of billings prior to submission. Formal requirements for management approval help ensure compliance with specific contract provisions. Progress payment requests in fact require some management certifications. When evaluating the adequacy of the contractor policies and procedures

for management reviews of billings, the auditor should consider whether:

- (1) contract briefings require management review and approval
- (2) managers review billings prior to submission
- (3) items or elements are identified for specific review
- (4) established thresholds and management approval levels are appropriate
- (5) managers have sufficient time to effectively review billings prior to approval.

5-1107.4 Reconciliation of Recorded and Billed Cost

a. The contractor should be able to demonstrate that billing requests are prepared directly from the cost accounting records or from other records which are reconciled to the cost accounting records. Billings prepared from subsidiary ledgers and/or memorandum reports must be reconciled to the general ledger by element of cost.

b. The contractor may identify normal reconciling differences and require any other differences to be subject to management review. Contractor identified differences other than those identified in 5-1101b above should be subject to additional auditor review. The contractor procedures and/or flowcharts should identify appropriate sources of inputs, internal control points, ancillary EDP applications, related transactions, and any documentation requirements. In manual systems the contractor may require the attachment of a copy of the job cost ledger or verification to the billing as a condition to the pre-submission approval process. In modern automated billing systems the billing data may be simultaneously posted to the cost and billing ledger or posted at specified intervals. However, the system should have the capability to input such things as billing ceilings, withholding requirements, or automatically code items which are not billable and then identify such cost suspensions or reconciling differences, on the face of the voucher or in a separate attachment (see also 5-1107.6, Exclusion of Unpaid Costs).

c. Periodic reconciliations of contract costs, as identified by the accounting system, to costs billed provides management necessary contract status information (e.g. cash flow, profit/loss, etc.), and allows the contractor to prepare timely final vouchers which detail allowable costs by contract by year.

5-1107.5 Adjustment of Cost and Rates

Interim billings of cost generally involve several contractor years. The status of incurred cost reviews changes as time passes, particularly with regard to indirect rates. Initially, billings may be based on projected rates for the year, which may change during the year as projections change; these rates should be monitored (FAR 52.216-7(e) and FAR 42.704) throughout the year and if significant deviations between billing rates and incurred rates occur during the year, or at year end, adjustments to the billing should be requested from the contracting officer. This process ensures that at year end the amount of indirect costs reimbursed is as close to the certified as possible. Similarly, direct costs may be subject to adjustments based on year-end procedures, audits and negotiations. Incurred cost billings are cumulative, and therefore, should reflect the impact of any of these adjustments as soon as they are known. The contractor should have procedures and controls in place to ensure the prompt adjustment of billings to reflect these adjustments in indirect rates and direct costs.

a. The contractor system should provide for the segregation of cost by year so that rate adjustments can be easily made and the rates used can be identified. Controls over who authorizes rate changes, or how unauthorized rate changes to contracts can be prevented should be clearly identified. Rate computations should be subject to easy verification.

b. To assure rates are current, the contractor should have a procedure which requires reapproval of rates at stated intervals (at least annually) or revision upon the occurrence of the events mentioned in 5-1107.5 above. These procedures should identify the organization responsible for establishing

billing rates, both projected and actual, as well as any adjustments to billing rates.

c. For tracking and documentation purposes, the contractor should maintain a rate folder or deck which identifies the date of rate changes and includes the supporting documentation (ACO or auditor approvals). Overhead and G&A expenses should be calculated on the basis of billing rates, quick close-out or final overhead rates. Billing rates should be properly certified as stated in FAR 42.704 and DFARS 242.770 (6-705 and 6-706).

d. Generally, direct cost adjustments are identified as suspensions or withholds on the face of the voucher or on a separate attachment.

5-1107.6 Exclusion of Unpaid Costs.

As discussed in the introduction, one of the primary differences between basic accounting records and billed government contract cost is the exclusion of unpaid or ineligible costs. It is essential that procedures and controls are established requiring the exclusion from billings of the following unpaid costs: (1) Accrued costs of direct materials and subcontract costs, (2) accrued costs that the contractor is delinquent in paying in the normal course of business; and, (3) accrued costs of pensions, post retirement benefits, and profit sharing or employee stock ownership plans that have not been paid at least quarterly (costs not paid within 30 days after the end of the quarter are not eligible for reimbursement). The specific clauses identifying reimbursable costs are in FAR 52.216-7b for vouchers and FAR 52.232-16(a)(2) for progress payments. The criteria are the same for both types of billings. When evaluating the adequacy of the contractor procedures, the auditor should determine:

a. Potentially nonbillable direct costs are, when possible, automatically coded and identified as such in the accounting or billing ledger data based on programmed criteria applied to cost ledger source codes. This would include unallowable direct costs, unpaid accrued costs, and costs subject to special approval requirements or other contract limits such as overtime premium.

b. The billing system should identify and segregate any nonbillable direct costs that cannot be identified to a program or job order. Such costs should be reclassified as billable, only when required conditions have been met. For example, another input may be needed when subcontract accruals have been paid.

5-1107.7 Subcontractor Progress Payments

FAR 52.232-16(j) requires the contractor to exclude costs of progress payments made to subcontractors on terms less favorable to the government than the progress payment clause contained in the prime contract. When evaluating the adequacy of the contractor policies and procedures for subcontracts, the auditor should determine whether the contractor has purchasing policies and procedures which are adequate to assure that the terms of subcontracts or interdivisional fixed price orders are the same as FAR 52.232-16(j) (CPSRs may be used to determine the adequacy of this area). In addition, the contractor should have policies and procedures to ensure monitoring of performance and expected profitability under subcontracts, review and approval of the subcontract progress payments and resultant reductions in upper tier progress payments, or reductions or suspensions of subcontractor progress payments, as necessary to protect against overpayment and losses.

5-1107.8 Estimates to Complete, Estimates of Costs of Delivered/Invoiced Items

a. Estimates to Complete. For progress payment purposes the amount on line 12b on the SF 1443, Contractor's Request for Progress Payment, is critical in the determination of the reasonableness of the request because it is used in the computation of the various critical limitations of reimbursable cost as discussed below. Because it is a critical factor, the FAR requires that the contractor keep these estimates to complete current (not more than 6 months old). The contractor should have policies and procedures to assure the most current estimates are used in progress payments, that these estimates reconcile with other external

reporting requirements such as C/SCSC and the FPI limitation on payment requests, and other contractor internal/external reports. Based on the adequacy of the contractor budgetary system, these estimates should be taken directly from those systems used to report status to contractor upper management. The contractor may have EDP controls or tickler files that identify in some manner when the estimates exceed the 6 month requirement. However, contractor procedures should also require significant changes in the estimate to be included in the progress payment even if they occur prior to the 6 month update.

b. Estimates of Costs of Delivered/Invoiced Items. Because costs by individual deliverable item are not generally available from cost accounting records, the contractor generally computes the costs of items delivered by applying the estimated cost/price ratio to the contract price of items delivered. The cost/price ratio is computed by dividing the estimate of costs to complete (line 12a plus line 12b) by the contract price (line 5). The contractor should have policies and procedures which describe how the estimated cost for delivered items is computed or how actual costs are determined.

5-1107.9 Loss Contract Procedures

a. The contractor should have policies and procedures to provide for the computation of loss ratios and adjustments of billings on potential loss contracts for the contractual coverages that have resulted in the loss. FAR 32.503-6(g) loss contracts, CAM 14-200 and the progress payment audit program provide examples of these loss computations. The estimate at completion (line 12a plus 12b) is used to determine the loss ratio to be applied to incurred costs to adjust for loss contracts.

b. Alternate Liquidation Rates. The estimate at completion is also used to verify the continued applicability of liquidation and alternate liquidation rates which impact the unliquidated balance of progress payments.

5-1107.10 Title to Assets

When the contracting officer has given the contractor consent to dispose of property under the progress payment clause (FAR 52.232-16(d)), the procedures should assure that the contractor disposes of the property systematically over the life of the contract, and appropriate credit is applied against the contract for the disposal proceeds. The contractor's failure to dispose of the property before contract completion could cause the government to lose the credits, since title to all property not delivered to and accepted by the government is vested in the contractor upon completion of all obligations under the contract. The contractor should have policies and procedures which require prompt disposal of property charged to fixed price contracts that are not deliverable end items.

5-1108 Implementation of Policies and Procedures

Written policies and procedures help ensure that internal control objectives are documented. The contractor should ensure that these written policies and procedures are executed to assure only billable costs/prices/fees applicable to government contracts are included in billings in accordance with applicable regulations and contract terms. In addition, the contractor should have policies and procedures to ensure that all changes which impact how billings are prepared are promptly disclosed to the government.

5-1108.1 Disseminating Policies and Procedures

In order for policies and procedures to be effective they must be communicated to the employees responsible for implementing them. Employees should be made aware of the existence of the policies and procedures and they should have ready access to them. The auditor should be alert for aspects of the billing process that are not covered by policies and procedures, especially dealing with external data entry, data correction, and supervisory approvals. Additionally, the auditor should note any instances where actual practices are inconsistent with

formal policies and procedures. In these instances, the auditor should consider the underlying cause for these inconsistencies.

5-1108.2 Training Applicable Employees

Merely making employees aware of policies and procedures and providing access to them, does not assure employees know how to interpret and execute them. Therefore, the contractor should provide training to the applicable employees. This training should include the topics described in 5-1107.1c above. The contractor should have training records—course materials and attendance sheets that document employee training. If the contractor does not provide formal training, evaluate alternative procedures that ensure that employees and management involved in the billing process have the required knowledge. The auditor may consider making inquiries of employees who performed a procedure and inspect documents and reports to ensure that employees are knowledgeable.

5-1108.3 Briefing Contract Requirements

Contract briefings should reflect contract requirements and these contract requirements should be reflected in the billings. The requirements may be docu-

mented either in a contract brief or directly into an automated system. Policies and procedures should ensure that contracts are adequately briefed and updated as modifications are received. When evaluating the adequacy of the contractor briefings, contract requirements in the briefing matrix at 3-202 should be used.

5-1108.4 Management Review and Approval

Effective procedures require that all billings, including final billings, are subjected to management review prior to their submission. The contractor should have procedures and controls in place to ensure that vouchers and invoices are accurate and have the appropriate level review and approval prior to their submission. The review should be evidenced by approval on the billing in accordance with contractor policy. When evaluating the reviews the auditor should use the guidance in 4-1000.

5-1109 Internal Control Reporting

The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on internal controls relative to the contractor's accounting and management systems.

5-1200 Section 12 — Surveys of Contractor Estimating Systems**5-1201 Introduction**

a. Refer to 5-101 for the auditor's fundamental requirements for obtaining and documenting an understanding of a contractor's internal control structure and assessing control risk.

b. This section provides guidance for conducting surveys of contractor estimating systems and discusses the requirements of DFARS 215.811 and 252.215-7002.

5-1201.1 Definitions

a. "Estimating System" is a term used to describe a contractor's policies, procedures, and practices for generating cost estimates which forecast costs based on information available at the time. It includes the organizational structure; established lines of authority, duties, and responsibilities; internal controls and managerial reviews; flow of work, coordination, and communication; and estimating methods, techniques, accumulation of historical costs, and analyses used by a contractor to generate cost estimates and other data included in proposals submitted in the expectation of receiving contract awards (DFARS 215.811-70).

b. "Significant Estimating System Deficiency" means a shortcoming in the estimating system which is likely to result in proposal estimates for either total cost or a major cost element which are consistently unacceptable as a basis for negotiating fair and reasonable prices (DFARS 215.811-70).

NOTE: Whenever significant deficiencies are outstanding, the overall opinion on the estimating system should be either inadequate or inadequate in some respects. Further, a recommendation should be made to disapprove the part of the estimating system that is deficient - see 9-1114.3g and 10-408a(z).

5-1202 Background

DFARS 215.811 requires all DoD contractors to have adequate estimating systems, requires certain large businesses to disclose their estimating systems in writ-

ing, provides guidelines concerning the characteristics of an adequate estimating system, and provides guidance for conducting team estimating system surveys.

5-1202.1 Applicability of DFARS 215.811

a. It is DoD policy that all contractors have estimating systems that consistently produce well supported proposals acceptable as a basis for negotiating fair and reasonable prices. Estimating systems should be consistent and integrated with a contractor's related management systems, and be subject to applicable financial control systems (DFARS 215.811-70). To be considered adequate, an estimating system must be established, maintained, reliable, and consistently applied. It must also produce verifiable, supportable and documented cost estimates (DFARS 215.811-70).

b. Any business contractor which in its preceding fiscal year received DoD prime contracts or subcontracts of at least \$50 million requiring certified cost or pricing data is subject to the requirements of DFARS 215.811-70 and paragraphs (d) and (e) of DFARS 252.215-7002 (see 5-1202.2, 5-1203.2, 5-1204.1 and 5-1204.2).

c. Any business contractor which in its preceding fiscal year received DoD prime contracts or subcontracts of at least \$10 million requiring certified cost or pricing data may also be subject to the requirements of DFARS 215.811-70 and paragraphs (d) and (e) of DFARS 252.215-7002. Such coverage is required if the PCO, with the concurrence or at the request of the ACO, determines it to be in the best interest of the government (e.g., significant estimating problems are believed to exist or the contractor's sales are predominantly to the government). The additional coverage will apply if during contract performance the contracting officer provides written notification to the contractor.

d. The disclosure, maintenance and review requirements of DFARS 215.811-70 do not apply to small businesses,

5-1202.1d.

educational institutions, or other non-profit organizations.

5-1202.2 System Disclosure and Maintenance Requirements

Contractors subject to DFARS 215.811-70 or notified in writing by the contracting officer that paragraph (d) of DFARS 252.215-7002 applies (see 5-1202.1b and c), are required to establish and maintain an adequate estimating system and disclose it in writing to the contracting officer responsible for contract administration. Disclosure is considered adequate when the contractor has provided the cognizant ACO with: documentation accurately describing the policies, procedures, and practices that are currently used in preparing cost proposals, and sufficient detail for the government to reasonably make an informed judgment regarding the adequacy of the contractor's estimating practices. Significant changes to the cost estimating system must be disclosed to the cognizant ACO on a timely basis. If disclosed information contains commercial or financial information which the contractor regards as privileged and confidential, such information will be protected and not released outside the government without the permission of the contractor.

5-1203 General Audit Policy

a. Refer to 5-103 for DCAA's general audit policy for the review of contractor accounting and management systems and related internal controls.

b. The auditor is responsible for evaluating contractor estimating methods and procedures. This is accomplished by estimating system surveys designed to determine the reliability of a contractor's estimates, identifying areas requiring special emphasis in the audit and negotiation of individual price proposals, and recommending improvements when deficiencies are noted in a contractor's estimating system. Estimating system surveys provide knowledge of the strengths and weaknesses in a contractor's estimating system. Effective reporting on the existence and impact of estimating system deficiencies can stimulate contractor corrective action. Corrective action can

substantially reduce the incidence of defective pricing and the time and effort required to audit individual price proposals.

c. It is DCAA's policy that contractor estimating system reviews be performed every three years unless past experience and current audit risk is considered to be low. A determination of low risk must be fully documented. In addition to a current audit risk assessment and documented past experience, the documentation must also include evidence of coordination with the ACO, and a written waiver from the Regional Audit Manager. If the audit risk is considered to be high, estimating system reviews should be performed more frequently. These reviews should also be considered at non-major contractor locations where there are indications of significant estimating system problems. Such reviews may be performed in conjunction with other planned contract audit activity.

5-1203.1 Comprehensive Estimating System Surveys

a. Most estimating system surveys are conducted as comprehensive surveys. Comprehensive surveys pertain to effort accomplished primarily by auditors, although technical specialist assistance is recommended for the quantitative and qualitative aspects of the survey. (See Appendix D for guidance on the use of technical specialists.) Comprehensive surveys are conducted at contractor locations not requiring a team review (see 5-1203.2). Auditors assigned should include individuals normally involved in the evaluation of the contractor's proposals. A regional office representative should also be available, if required, to provide advice and assistance in planning and conducting the survey.

b. The guidance contained in 5-1204 through 5-1212 forms the basis for evaluating a contractor's estimating system. Although much of the guidance refers to team reviews, it may also serve as the basis for performing comprehensive surveys.

5-1203.2 Team Reviews

a. Definition. Team reviews pertain to effort accomplished as a DCAA and

contract administration office team effort in accordance with DFARS 215.811-70.

b. Selection of Contractors for Team Reviews.

(1) Team reviews apply to contractors subject to DFARS 215.811-70 (see 5-1202.1b and c). DCAA and the cognizant contract administration activities are to establish and manage regular programs for reviewing selected contractor estimating systems (DFARS 215.811-70). Factors to consider in selecting contractors for a team review follow:

(i) The annual DoD sales under prime contracts and subcontracts in the preceding fiscal year requiring certified cost or pricing data (should normally be at least \$50 million).

(ii) The frequency of proposals subject to price analysis and audit.

(iii) The date of the last team review.

(iv) Any special pricing problems.

(2) Team reviews are to be conducted at least every three years at applicable contractors, except where the auditor and ACO determine that recent past experience has not found significant deficiencies and the current audit risk is low. A determination of low risk must be fully documented. In addition to a current audit risk assessment and documented past experience, documentation must also include evidence of auditor and ACO coordination, and a written waiver from the Regional Audit Manager. Some examples of low risk indicators follow:

(i) No significant contractor reorganization has occurred which could affect its estimating or accounting functions.

(ii) The contractor has not adopted major changes in its estimating methods or procedures.

(iii) The contractor has carried out and submitted to the government periodic self-assessments of its estimating practices and procedures using the Contractor Risk Assessment Guide (CRAG) or similar self-governance programs, which substantiate the reliability of its system (see 3-104.4e).

(iv) There is no other evidence indicating the estimating system contains a major deficiency.

(3) If the auditor and ACO determine that the government is subject to high risk, estimating system surveys should be

done more frequently. However, the auditor's objective should be to work with the ACO and contractor to correct the deficiencies rather than perform more frequent reviews of the estimating system.

(4) At the beginning of each fiscal year, regional offices will coordinate a list of contractors selected for a team review with the responsible contract administration office (regional or other supervisory office).

c. Team Makeup and Responsibilities.

(1) The team will consist of members of the cognizant audit office, and technical specialists designated by the responsible contract administration office. The contract auditor will be designated as the team leader and is to be assigned responsibility for survey planning, direction of the work, and report finalization. Depending upon the nature of the contractor's activities, the contract administration office will designate quality control, production, engineering, packaging, transportation, and/or other specialists. Both offices are to assign sufficient personnel to permit completion of the review and issuance of the report within a reasonable time. If technical specialist assistance cannot be provided, inform the regional audit manager so the region can elevate the matter to appropriate acquisition management officials. If technical assistance is still not provided, the region should elevate the matter to DCAA Headquarters (Attn: OPD). DCAA Headquarters will attempt to obtain the technical support. In those instances where DCAA Headquarters is not successful and believes that further resolution is required, Headquarters will direct the request to the attention of the Assistant Secretary of Defense (Production and Logistics). DCAA will not, in any case, use its own resources to perform these specialist functions.

(2) To provide for an efficient and effective audit, auditors and technical specialists assigned as team members should include individuals normally involved in the evaluation of the contractor's price proposals.

d. Regional Office Assistance. Regional offices are to assist in resolving problems relating to the scheduling of specific team

surveys, the participation of technical specialists on survey teams, and disputes between a team member and the team leader on survey findings and recommendations (see 5-1205.2c). Regional offices will also provide advice and assistance in planning and conducting the survey, as required.

5-1204 Audit Objectives

a. The purpose of this audit is to evaluate the adequacy of and the contractor's compliance with the estimating system's internal controls. Refer to 5-104 for DCAA's primary objectives for auditing the contractor's accounting and management systems.

b. There is a clear interrelationship between estimating system, price proposal, and defective pricing audits. It is important that the auditor recognize that the results in one or more of these areas will have a direct relationship on the scope of audit in the other area(s). In addition to meeting the DFARS requirement for review, an estimating system survey serves as the fundamental basis for determining audit risk and scope for future price proposal and defective pricing audits. The primary objectives of the survey are to: (1) evaluate the adequacy of a contractor's system for developing cost estimates for price proposal purposes, (2) evaluate a contractor's compliance with its written estimating procedures and disclosed estimating system (if applicable), (3) identify areas of a contractor's estimating system requiring special emphasis or attention during the audit and negotiation of individual price proposals, and (4) inform interested government activities on the reliability of a contractor's estimating system, and of actions necessary to correct existing deficiencies.

5-1204.1 Characteristics of an Adequate Estimating System

The adequacy of an estimating system depends on the successful interrelationship of many variables. The relative importance or necessity of each is largely determined by the particular conditions existing at each contractor location. In general, adequate estimating systems

should provide for the use of appropriate source data, utilize sound estimating techniques and appropriate judgment, maintain a consistent approach, and adhere to established policies and procedures. Although it is not possible to list all characteristics that should be present in an adequate estimating system, DFARS 215.811-70 states that in evaluating the adequacy of an estimating system, the ACO should consider whether the contractor's estimating system:

a. establishes clear responsibility for the preparation, review, and approval of cost estimates

b. provides a written description of the organization and duties of personnel responsible for preparing, reviewing, and approving cost estimates, and the various functions contributing to the estimating process such as accounting and planning

c. ensures that relevant personnel have sufficient training, experience, and guidance to perform estimating tasks in accordance with the contractor's established procedures

d. identifies sources of data and the estimating methods and rationale used in developing cost estimates

e. provides for appropriate supervision throughout the estimating process

f. provides for consistent application of estimating techniques

g. provides for detection and timely correction of errors

h. protects against cost duplication and omissions

i. provides for the use of historical experience where appropriate

j. requires use of appropriate analytical methods

k. integrates information available from other management systems as appropriate

l. requires management review including verification that the company's estimating policies, procedures, and practices comply with DFARS 215.811

m. provides for internal review of and accountability for the adequacy of the estimating system, including the comparison of projected results to actual results and an analysis of any differences

n. provides procedures to update cost estimates in a timely manner throughout

the negotiation process (Also see 14-120.4 on defective pricing sweeps.)

o. addresses responsibility for review and analysis of the reasonableness of subcontract prices

5-1204.2 Indicators of Potentially Significant Estimating Deficiencies

Some indicators of, or conditions that may cause, significant estimating deficiencies as discussed in DFARS 215.811-70 are listed below. These indicators or conditions are not intended as a comprehensive checklist. They may, however, suggest the need for further analysis or evaluation. Since estimating is not an exact science and is partly based on judgment, differences between individual estimates and subsequent actual data are not necessarily indicators of a significant estimating system deficiency.

a. Failure to ensure that relevant historical experience is available to and used by cost estimators as appropriate.

b. Continuing failure to analyze material costs or failure to perform subcontractor cost reviews as required.

c. Consistent absence of analytical support for significant proposed cost amounts.

d. Excessive reliance on individual personal judgment where historical experience or commonly used standards are available.

e. Recurring significant defective pricing findings within the same cost element(s).

f. Failure to integrate relevant parts of other management systems (e.g., production control or cost accounting) with the estimating system, impairing the ability to generate reliable cost estimates.

g. Failure to provide established policies, procedures, and practices to persons responsible for preparing and supporting estimates.

Not all estimating system deficiencies will be significant as defined in DFARS 215.811-70 (see 5-1211f). For example, the lack of written policies and procedures for a seldom-used cost estimating relationship is not necessarily an indicator of a significant deficiency when considered in the context of an otherwise adequate estimating system.

5-1205 Scope of Audit

a. While the nature and extent of audit effort depends upon contractor size, amount of government business, and audit risk, (materiality and sensitivity), the audit scope should be consistent with the guidance in 5-105.

b. Controls for interrelated audit concerns regarding the adequacy of the contractor's other major systems (i.e., budgets, general accounting, etc.) will be audited under separate assignments. While the controls for these areas are not part of this audit, the results of all audits of these interrelated controls must be considered in forming an overall audit conclusion on the estimating system internal control structure and also commented on in the related audit report.

c. The extent of audit effort should also be influenced by:

- (1) the types of government contracts and their materiality
- (2) deficiencies noted in recent proposal and postaward audits
- (3) deficiencies noted in the prior estimating system survey and flash estimating system reports
- (4) participation of the contractor in self-governance programs (this includes the work performed by the contractor's internal audit staff)
- (5) input from the contracting officer
- (6) contract provisions

General information regarding these scope areas is provided in 3-104 and additional considerations specific to the estimating system are discussed below. A risk assessment documenting conclusions reached regarding the impact of the above areas on the scope of this review should be documented in the working papers.

d. If possible, estimating system surveys should be completed in a timely and efficient manner early in the year. By minimizing the cycle time and completing the review early, the results can be used in assessing control risk when establishing the scope for audit effort on price proposal and defective pricing audits.

5-1205.1 Coordinating Team Reviews

Preparation for an effective audit requires proper coordination with interest-

ed procurement and contract administration activities, and the contractor as follows:

a. Approximately 30 to 60 days before the scheduled starting date, notify in writing each government procurement office having a significant volume of business with the contractor that an estimating system survey will be made. Request comments on any problems or special areas of interest related to the contractor's price proposals which would be appropriate for consideration.

b. Contact the ACO to discuss personnel and technical specialist requirements, survey scope, time phasing of the work, and the planned entrance conference with the contractor. Request that the ACO designate a member of his or her staff to coordinate the activities of the technical specialists assigned to the team. If the contractor is subject to DFARS 252.215-7002(d) (see 5-1202.1b and c), determine if it has disclosed its estimating system in writing to the ACO as required. If disclosure has not been made, immediately issue an estimating system deficiency flash report (see 9-310, 9-1212b, and 10-10S2) and recommend that the ACO obtain the disclosure. In addition, report this deficiency in all subsequent forward pricing audit reports issued until corrected. Also consider deferring the estimating system survey until disclosure is made. If, however, you have leads or suspect that significant estimating system deficiencies exist, continue the audit.

c. Inform the contractor of the planned survey by sending a letter to the management official responsible for the total operations of the organizational unit being surveyed. Describe the purpose and general scope of the survey, indicate the tentative starting date, and identify the team leader and key participants. Request the contractor designate a company representative from its estimating department with whom survey matters can be coordinated. Also request that the contractor alert contributing departments of the planned survey and of their need to provide information and records required by the survey team. Identify data needed at the beginning of the survey and propose a date for an entrance confer-

ence. Invite the contractor's top management personnel to attend the entrance conference. Suggest that the contractor present an orientation briefing at the entrance conference on its organizational structure, operating policies, and other areas of concern to the review team. Invite a prompt reply and provide a copy of the letter to the ACO.

d. Prior to the entrance conference, hold a preliminary meeting with team members to develop a tentative survey program. The team leader will ensure that overall survey scope will be responsive to procurement and audit needs.

e. Conduct the entrance conference in accordance with 4-302. Explain the purpose of the audit, the overall plan for its performance, the estimated duration, and the types of books, records, and data to be evaluated. Also allow enough time for the contractor to present an orientation briefing (see 5-1205c.(3)). Discuss the Contractor Risk Assessment Guide (CRAG) program (see 3-104.11e.) with the contractor and explain its relevance to estimating system surveys. If the contractor participates in the CRAG program or other related self-governance programs for estimating systems, describe the effect of this participation on the scope of audit. If the contractor is not a participant in self-governance, explain the benefits of these programs. Describe how it can strengthen internal controls and thereby reduce audit scope and decrease the frequency of estimating system surveys.

f. Shortly after the entrance conference, hold another team meeting to finalize survey plans and make appropriate modifications to the survey program. Assign specific program areas to individual team members and establish time-phased schedules. Tailor the survey to take advantage of the daily work performed as part of the normal activities of the contract audit and contract administration functions.

5-1205.2 Areas of Coverage and Team Assignments

a. At any contractor location, certain areas of coverage or survey steps may be inapplicable, or applicable only in part. Read 5-1206 through 5-1210 to obtain a

general understanding of the potential coverage requirements. Develop a survey program appropriate for the specific contractor location under review. A pro forma estimating system audit program is on the FAO DIIS subsystem under file name APESTG.

b. For areas of coverage dealing with the development of quantitative and qualitative requirements, carefully plan and coordinate with the technical specialists to eliminate duplication of effort and to ensure adequate audit coverage. The assignment of specific steps to an auditor, a technical specialist, or both depends upon the conditions encountered at each location. Base assignments to team members upon mutual agreement as to who can most effectively perform the work.

c. An auditor's areas of coverage will normally include cost and production records and data, learning and improvement curves, bills of material, operation or process time sheets, and other similar documentation. Such documentation provides a factual basis for determining the adequacy of a contractor's system for developing material and labor quantities and related usage, scrap, spoilage, and efficiency factors.

d. Technical specialists will normally be assigned to areas requiring technical knowledge and judgmental evaluations. Such areas include production processes, shop practices, machine loadings, time-and-motion factors, drawings and specifications, and engineering principles and techniques. They may also be required to evaluate data relating to plant layout and rearrangement, planning and scheduling plant capacity, and value engineering.

e. In assigning specific steps to team members, recognize that auditors and technical specialists have a common interest in:

- (1) The quantitative aspects of the contractor's estimates.
- (2) The methods by which requirements for the various types and quantities of labor hours and material are determined.
- (3) Other areas such as special tooling and test equipment, packaging, and technical data.

5-1205.3 Team Monitoring and Coordination

a. Although technical specialists are responsible for the execution of their assigned functions, the team leader will coordinate the efforts and monitor the progress of all team members. The team leader will evaluate the scope of coverage and results obtained and determine with team members if efforts should be curtailed or expanded, or methods modified. All team members should adhere to professional standards, particularly those pertaining to the preparation of adequate working papers.

b. The team should meet periodically to resolve problems encountered and discuss progress and interim findings. The team leader should be currently informed of all interim findings so they may be referred for further development and consideration by other team members examining related areas.

c. Resolve any disagreements between a team member and the team leader at the local level so that coordinated views are reflected in the survey report. If resolution cannot be obtained at the local level, refer the matter to the DCAA regional office and, if appropriate, the contract administration counterpart. In unusual cases involving broad policy, refer the matter to Headquarters, Attn: OPD.

d. Coordination with the ACO is essential throughout the survey. The team leader should actively solicit the personal participation of the ACO at the entrance and exit conferences. The team leader should also keep the ACO currently informed of significant developments. After completion of the field work and before the final report is issued, review all significant findings and recommendations with the ACO. Also review any substantive changes made after this point with the ACO.

5-1206 Internal Audits

The estimating system should be subjected to periodic internal audits to ensure the following:

- (1) The policies and procedures comply with applicable rules and regulations.
- (2) Established policies and procedures are being followed.
- (3) Prior internal audit findings have been properly dispositioned.

This objective recognizes the contractor's commitment to self-governance and its contractual responsibility for systems and accounting internal controls. The contractor should be conducting on-going, self-initiated reviews of various aspects of its estimating system in a timely manner. Contractors may comply with this standard using in-house staff efforts or through the services of outside consultants.

a. Our interpretation of "internal audits" for purposes of this objective includes reviews performed by functional units as well as the internal audit staff. The auditor must be aware of the requirements of CAM 4-1000, Relying on the Work of Others. The level of objectivity and competence of personnel performing the reviews will have a significant impact on the reliability of the reviews and should be clearly communicated to the contractor. Both the auditor and the contractor should be aware that the objective is to ensure that adequate estimating system policies, procedures, and controls are in place and being followed, and that system adequacy is maintained on a real-time basis.

b. The auditor must ensure that the system is subjected to periodic internal audit. This objective does not create additional access requirements beyond those identified in FAR 52.215-2 and CAM 1-504. Consideration should be given to both the contractor's internal audit schedule of completed audits and audits performed by functional units that meet this objective. If the contractor contends that such reviews have been performed but is unwilling to make them available to DCAA in any form, the auditor may be unable to determine if the contractor has met this objective. The auditor must evaluate the need for such access. Denial of access to relevant data should be escalated in accordance with CAM 1-504.

c. The contractor cannot comply with the system disclosure and maintenance requirements if it does not provide to the government "sufficient detail" for the government to reasonably make an informed judgement regarding the adequacy of its estimating practices. If the internal auditor performs work supporting the system disclosure and maintenance effort, access to the detailed work products is necessary to assess the adequacy of the estimating practices.

d. If a contractor is not performing periodic reviews of its estimating system, then it should be reported for not achieving this objective. This should be reported as a serious internal control weakness in light of the complexity of the estimating system and the risk of inaccurate costs being proposed on government contracts. This control weakness should also be tied to prior questioned costs, were applicable.

5-1207 System Description

a. The contractor should have an adequate estimating system description including policies, procedures, and operating instructions compliant with FAR and DFARS. While the contractor is required to provide a broad range of documents, the auditor should focus attention on the adequacy of the policies, procedures, and operating instructions related to the control objectives outlined in the remainder of this section.

b. The contractor should provide a written description of its estimating system in enough detail to allow the auditor to get a thorough understanding of how the system operates. The contractor's write-up should include items listed below:

- (1) The overall organization and assignment of responsibilities.
- (2) References to written policies and procedures.
- (3) The flow of information between each process or function within the system as well as other management systems.

5-1207.1 Evaluation of Contractor's Organization and Assignment of Responsibility

The estimating function may be organized differently by individual contrac-

tors because of differences in their products or services, industry practices, size and type of organization, degree of departmentalization, management attitudes, personnel capabilities, and other factors. Responsibility for developing estimates may be centralized in an estimating group or delegated to the various participating departments. However, the estimating function should be soundly organized on the basis of a definitive flow of authority and standard policies and procedures established at a top or upper management level. Each contractor should maintain a written description of the organization and the duties of personnel responsible for preparing, reviewing, and approving cost estimates, and the various functions contributing to the estimating process such as accounting, planning, training, etc.

a. Evaluation of a contractor's organization requires analysis of the relationship of the organizational segments participating in the estimating function. For this purpose, request that the contractor provide organization charts and written procedures or directives describing the organizational structure and responsibilities of the estimating group(s) and contributing departments. Request flow charts from the contractor which show the flow of work in the estimating process, from the initiation of a proposal to the contract certification date, and the integration of data prepared by personnel responsible for functions such as accounting, cost control, budgeting, estimating, planning, purchasing, production control, engineering, and sales.

b. The auditor should determine if:

- (1) Preparation of required estimates is effectively controlled either on a centralized or decentralized basis.
- (2) Lines of authority, duties, and responsibilities are clearly defined, including responsibilities for preparing, reviewing, and approving cost estimates.
- (3) The estimating process is properly coordinated among segments of the organization responsible for different parts of the estimate.
- (4) The department responsible for overall compilation of the estimate has authority to review and ques-

tion the reasonableness or accuracy of feeder information received from other departments.

5-1207.2 Evaluation of Policies and Procedures

The estimating function is of such importance that direction and guidance for its implementation must be in a form that ensures complete understanding and precludes misunderstanding. A formal written statement of policies and procedures, rather than an informal one based on established customs of the organization, should exist at all contractor locations with substantial government business. Estimating procedures represent the means by which policies and objectives established by management are translated into detailed guidance and direction to personnel engaged in estimating functions. Policies and related implementing procedures should cover such areas as estimating organization; lines of authority; formats for proposal preparation; make-or-buy determinations; quantitative and pricing aspects of each cost element; use of statistical aids and estimating techniques (e.g., learning curves and scatter charts); extent of documentation; and review and control requirements.

a. Determine if standard policies have been established at a sufficiently high organizational level, and are in sufficient depth and detail to serve as a basis for definitive implementation.

b. Evaluate procedures for compatibility with underlying policy and for completeness as a source of guidance in all aspects of proposal preparation. Procedures should cover matters such as:

- (1) Designation of individuals authorized to initiate and approve requests for preparing estimates.
- (2) The required form of the request and the supporting detail to accompany the request. The latter includes documents such as the technical proposal, supplemental statement of work required under the proposed contract, and performance schedules.
- (3) The basis for control, time phasing, review and approval of the estimate, and for the orderly flow

of documentation and data in the buildup and support of the estimate.

- (4) Methods for obtaining contributions from, and coordination among, segments of the organization responsible for different aspects of the estimate. Such segments include engineering, quality control, purchasing, accounting, budgeting, and production control.
 - (5) Format of the estimate and the detail required to support it.
 - (6) Identifying the sources of data and estimating methods and rationale used in developing cost estimates.
 - (7) The consistent application of estimating techniques.
 - (8) Use of appropriate analytical methods.
 - (9) Procedures to update cost estimates in a timely manner throughout the negotiation process.
 - (10) Pricing of component cost elements with emphasis on using the most accurate, complete, and current cost and pricing data available at the time the estimate is prepared. (If the contractor makes more than one estimate for the same component of cost, all estimates should be available for the government's evaluation.) To the extent applicable, maximum use should be made of historical cost data for pricing the same or similar items or services, or elements thereof. Procedures should also provide for furnishing current, accurate and complete data up to the date of the price agreement, for estimates requiring the execution of a certificate of current cost or pricing data.
 - (11) Responsibility for review and analysis of the reasonableness of subcontract prices.
- c. Evaluate estimating procedures to determine if they are kept current, disseminated to all responsible employees, and consistent with the company's established cost accounting policy, system, and procedures.

5-1207.3 Integration with Other Management Systems

a. Cost Accounting System. The contractor's cost accounting system is usually a major source of data used in developing cost estimates. An evaluation of a contractor's cost accounting system is normally accomplished separately from an estimating system survey (9-302). One area which should be covered in an accounting system evaluation is the impact on the system of technological modernization (see 14-800). Any changes to the accounting system must be disclosed to and approved by the ACO. The following areas should be covered in an estimating system survey. (Reliance placed upon separate accounting system evaluations should be documented in accordance with 4-1000.)

(1) The extent to which cost accounting and adjunct statistical records contain sufficient refinements for cost estimating purposes. Examples of such refinements are lot costing and the segregation of nonrecurring costs.

(2) The consistency between estimating and cost accounting in the classification of cost elements as either direct or indirect. Determine the reasons for any inconsistencies and their effect upon the validity of cost estimates and indirect cost rates.

(3) The suitability of the contractor's standard costs and related variances for use in preparing cost estimates, considering:

(a) The extent to which variances are segregated by product line and according to contributing causes such as price and rate variances, use and efficiency variances, and variances due to "make" versus "buy" decisions.

(b) The degree to which historical cost variances used for estimating are adjusted to reflect anticipated or planned changes in conditions.

(c) The magnitude of the variances and their composition. Variances should be documented by the contractor and evaluated by the auditor before they are accepted on future estimates.

b. Planning and Budgeting System. In addition to serving as a management control over the cost of operations, the

contractor's budget system also provides data for use in developing estimates, particularly indirect cost projections and volume of activity forecasts. Contractor budget system audits should be made separately and preferably in advance of estimating system surveys (see 5-500). The following areas, however, should be considered during an estimating system survey. (Reliance placed upon separate budget system audits should be documented in accordance with 4-1000.)

(1) The degree to which the projected level of costs and volume of activity are considered in preparing cost estimates.

(2) The reliability of sales forecasts and the extent to which such forecasts are reflected in indirect cost projections.

(3) Consideration given by the contractor when preparing cost estimates to information contained in facilities budgets, e.g., commitments for the acquisition of new and improved equipment expected to reduce production costs.

5-1208 Training

The proper functioning of any system is dependent upon the ability of employees to operate the system in a manner consistent with its original design. To do this, employees must have sufficient training, experience, and guidance. The contractor's policies and procedures should provide for the training of employees involved in the estimating process to ensure that they understand the process employed to develop cost estimates and the proper use of estimating techniques.

a. Training should be provided to appropriate employees (including technical employees) on government regulations and company policies and procedures pertaining to the estimating process. Training on the use of statistical aids and advanced estimating techniques including appropriate proposal file documentation procedures should be provided.

b. Training modules should be periodically reviewed and updated and periodic training sessions provided for new hires and experienced personnel.

5-1209 Evaluation of Cost Estimate Development

a. A major part of the survey is an evaluation of the effectiveness of the methods and procedures used to develop estimates of individual cost elements. A contractor should ensure that estimating source data is appropriately applied and the basis for estimating each cost element is disclosed by providing written guidelines for developing and supporting consistent and verifiable proposals. Procedures and instructions on the documentation required for a proposal should cover items such as:

- (1) Conditions, assumptions, and qualifications.
- (2) Basis of each cost element including the methods and support used to develop indirect rates, pools and bases.
- (3) Milestones for contract performance.
- (4) Reconciling detail and summary level data.

b. In determining the scope and extent of coverage to include in the program for this part of the survey, team members should consider the preliminary survey work accomplished and the prior experience of the auditors and technical specialists. Give particular attention to costs questioned and findings disclosed during price proposal and postaward audits. Comparisons of previous estimates with actual costs of completed negotiated contracts may also furnish useful information, provided the methods used to develop such estimates are still in effect. Do not request that the contractor submit special data for this purpose if its preparation requires extensive effort.

c. Where information developed under recent incurred cost, price proposal and other audits provides the basis for an informed conclusion regarding a particular area of coverage, no further steps are needed for the evaluation of that area. However, reliance placed upon these other audits must be documented in accordance with 4-1000. Where further effort is considered necessary, use recent price proposals previously submitted by the

contractor to test the effectiveness of the contractor's procedures.

5-1209.1 Estimating Methods

The methods employed by a contractor to develop cost estimates may vary depending on the type of work covered by a proposal, e.g., research, production, etc. Request the contractor to provide a flow chart for each type of proposal, showing how individual cost elements are developed and integrated into the total estimate. In addition, evaluate the estimating methods employed by the contractor in preparing various proposals to consider:

a. Appropriateness of the estimating methods employed in preparing cost estimates for each type of proposal, and if different methods should be used considering factors as:

- (1) Nature of product or service.
- (2) Degree of firmness of specifications.
- (3) Contractor's prior experience with the same or related products or services.
- (4) Extent detailed cost data can be derived from the accounting system, adjunct statistical records, and other sources.
- (5) Relative dollar amount of estimates.
- (6) Cost and time restrictions on the preparation of estimates.

b. A contractor should clearly identify the pricing policy for areas identified as sensitive by the government and contractor. Such areas include pricing policy for start-up costs on follow-on contracts; burdens for intracompany effort; inventory items including residual inventory; and government owned or furnished equipment.

c. Extent estimating methods make appropriate use of historical cost data relating to (1) entire products, (2) individual tasks required on new procurements similar to those accomplished under previous contracts, and (3) indirect cost ratios and percentage factors applicable to a common base.

d. If cost estimates based upon prior cost experience adequately consider:

- (1) Differences in complexity, quantity, rate of production, state of

development, etc., between items previously produced and those for which estimates are being developed.

- (2) Applicability of preproduction engineering, special tooling, plant rearrangement, and other nonrecurring costs.
- (3) Anticipated changes in production methods, material usage, prices, wage rates, labor efficiency, production volume, plant capacity, and make-or-buy structure.

e. The propriety of using company-wide forward pricing factors developed for the preparation of cost estimates and if such pricing factors are current, based upon reliable cost data and procedures, and correctly applied.

f. Applicability of historical standard cost variance factors. If standards have been revised to represent expected actual cost, historical cost variances are not applicable.

g. Reasonableness of formula pricing methods for spare parts to ensure individual elements of cost are not duplicated in base cost and loading factors.

h. Suitability of catalog pricing and prepriced listing methods for developing reasonable prices for spare parts proposals, if used by the contractor.

i. Acceptability of the contractor's methods for developing cost estimates for contract changes, considering:

- (1) Degree to which estimates properly reflect the nature and scope of the change and status of the work at the time the change is issued.
- (2) If work deleted by changes is priced correctly.

j. If there is effective use of the contractor's EDP capabilities in developing estimates and summarizing detailed data for proposal preparation.

k. If analytical methods are used, when appropriate, to develop cost estimates and/or evaluate the reasonableness of cost estimates developed using other procedures.

5-1209.2 Evaluation of Proposal Format and Support

A contractor's estimating procedures should provide a standardized format for proposals and the submission of support-

ing data. Estimating system documentation should include or reference policies and procedures on the formats for proposal preparation and the required detail for support. Where contractors are required to submit cost and pricing data to the contracting officer, use of an appropriate Standard Form 1411 or 1412 is specified for this purpose together with supporting schedules (see 9-304). Evaluation should cover:

a. Determination that proposals are submitted on appropriate forms (or acceptable substitutes) and all data required by the forms is furnished.

b. Sufficiency of detail contained in proposals and supporting data.

c. Adequacy of the contractor's identification of cost and pricing data submitted in support of the price proposal and the related Pricing Certification, when required by FAR 15.804.

5-1209.3 Subcontract Price/Cost Analysis

a. The contractor's policies and procedures should require that a price analysis be performed for all subcontracts if: (1) the subcontractor is required to submit cost or pricing data, or (2) the contractor is unable to perform an adequate price analysis, a cost analysis. The results of such analyses should be included as part of the contractor's cost or pricing data submission. Adequate and timely subcontract cost/price analysis is critical to the negotiation of fair and reasonable prime contract prices. For this reason, contractors should have policies and procedures in place to accomplish such analyses prior to the submission of their own cost or pricing data.

b. Due to time and other constraints, the contractor may be unable to perform a detailed price/cost analysis prior to submission of its own cost or pricing data. In these instances, the contractor's policies and procedures should require that a plan be in place to complete the required analyses and provide it to the government negotiator prior to negotiation of the prime contract price.

c. In some exceptional cases, the contractor may be unable to obtain adequate cost or pricing data and/or perform the required analyses prior to negotiation of

the prime contract price. The contractor's policies and procedures should provide for the timely identification of such circumstances and submission of a request, to the contracting officer, to be excused from the submission of subcontractor cost or pricing data and related analyses. This request should be supported by an (1) explanation as to why the data and analyses cannot be submitted in a timely manner, and (2) alternate analysis such as application of a negotiation reduction factor based on the historical difference between the initial subcontractor proposed amount and the ultimate negotiated amount.

5-1209.4 Evaluation of Contractor Control and Review of Estimates

The reliability of estimates depends largely upon the effectiveness of the internal controls and managerial reviews, including internal audits of the estimating function (see 5-1206), incorporated into the estimating process. Evaluate the contractor's estimating controls and reviews to determine the sufficiency of internal controls, including:

a. If the various phases and functions in the estimating process are adequately controlled to ensure timely processing of proposals.

b. If internal controls are adequate to ensure uniformity of approach, timely detection and correction of errors, and prevention of cost duplications and omissions.

c. If supervision in each area and at each level of the estimating process is adequate.

d. If management reviews of proposals cover the soundness of judgmental estimates and adherence to established procedures.

e. If estimators are required to summarize the conditions, assumptions, contingencies, qualifications, risks, etc., that were considered in developing estimates.

f. The quality, frequency, scope and results of management reviews of the estimating function. Such reviews should determine if the company's estimating policies, procedures, and practices comply with DFARS 215.811 and other applicable Federal regulations. They should also determine if the overall estimating

system is adequate. In doing so, they should compare, on a sample basis, projections to actual results, and analyze any differences. DCAA should evaluate management action and follow-up on reported findings and recommendations.

5-1210 Contract Certification

a. The contractor should have established policies and procedures for ensuring that all cost or pricing data is current, accurate, and complete as of the date of agreement on price. The auditor should review these policies and procedures to determine if they are adequate to reasonably ensure that the additional cost or pricing data will be identified and submitted to the government negotiator prior to execution of the Certificate of Current Cost or Pricing Data.

b. The auditor's review should carefully consider the results of recent postaward reviews in determining the scope of review for this objective. Additional audit guidance on Defective Pricing "Sweeps" is contained in 14-120.4.

5-1211 Summarization

a. Upon completion of each assigned area and appropriate supervisory review, the auditor will discuss his or her tentative findings and recommendations with contractor personnel responsible for the specific area evaluated. The purpose is to confirm the factual accuracy of the findings and assess the feasibility of the recommendations. After the discussions, the auditor should promptly summarize the specific areas evaluated and those that need to be reported upon, as follows:

- (1) An overall evaluation of the acceptability of the estimating methods and procedures applicable to the area.
- (2) A description of each condition requiring corrective action, and related recommendations in such form and detail as required for the survey report.
- (3) The contractor's reaction to that part of the findings and recommendations.

b. The ACO or a representative should coordinate the activities of the contract

administration office team members; consolidate the technical findings and recommendations; and, when appropriate, prepare a comprehensive written report to be submitted to the team leader. Attach this report to the overall estimating system survey team report. The contract administration activity will be responsible for the technical sufficiency and validity of the technical report(s). If requested technical assistance was not provided, qualify the estimating system survey audit report.

c. The technical specialists will retain their working papers. In some instances, copies of technical specialist summary schedules, etc., may be needed for the survey audit report. Such copies should be provided upon request of the team leader. These copies, as well as the reports of the team members and the detailed working papers prepared by the auditors, will be maintained in the survey file.

d. After completion of the field work, the team will meet to evaluate all findings and recommendations and establish the general content of the overall survey audit report. The team leader will prepare the report using the written input of the various team members. The team leader will coordinate the draft report with the ACO to resolve differences in conclusions or recommendations. Disagreements between a team member and the team leader in should be resolved in accordance with 5-1205.3b.

5-1212 Internal Control Reporting

a. The auditor should follow the guidance in 5-110, 10-200 and 10-400 for reporting on compliance with laws and regulations and on internal controls relative to the contractor's accounting and management systems. An example of a report on an estimating system survey is included on the DCAA Bulletin Board under the name NUFORMAT.ZIP.

b. If significant deficiencies are identified, the overall audit opinion on the system should be "inadequate in some respects" or "inadequate". Further, a recommendation that all or part of the estimating system be disapproved must be included in the report (DFARS

215.811-70. When making this recommendation, the estimating system survey report should include the estimated cost impact of each significant estimating deficiency. Calculation of the impact should be based on such factors as the amount of questioned and unsupported costs found in previous price proposal audits and the amount of recommended price adjustments found in previous postaward audits that are attributable to the estimating deficiency. Where appropriate, the report should also recommend that the ACO consider notifying contracting activities that cost or pricing data on negotiated procurements should be requested at the \$100,000 level.

c. The auditor should recommend disapproval of an entire estimating system when deficiencies are so significant that the system is likely to produce proposal estimates which in total are consistently unacceptable for negotiating fair and reasonable prices. This may be appropriate when defective pricing findings, or estimating system deficiencies adversely affecting audit or negotiations, consistently occur in all major cost areas.

d. Recommend disapproval of part of an estimating system when significant deficiencies are likely to produce proposal estimates with one or a few major cost elements consistently unacceptable for negotiating fair and reasonable prices. This may be appropriate when defective pricing findings, or estimating system deficiencies adversely affecting audit or negotiations, consistently occur in one or a few major cost areas.

e. Only significant estimating system deficiencies should be reported. Minor deficiencies are defined as those deficiencies that would not cause disapproval of all or part of the contractor's estimating system. If correction of the minor deficiencies would enhance the contractor's estimating system, these deficiencies should be addressed in a separate appendix to the report as suggestions for improvement.

5-1213 Exit Conference

After completion of the draft report, the team leader will arrange and conduct an exit conference attended by all team

members and the ACO. At the exit conference, discuss the results of audit and provide the contractor with a draft statement of the condition(s) and recommendation(s). Inform the contractor that its written response to the draft, if provided within a reasonable time, will be included in the audit report to the ACO (see 4-304.5b). After receipt of the contractor's response or lapse of a reasonable time, the team leader will issue the final report in accordance with 10-400. If findings are significant, send information copies to each procurement office doing substantial business with the contractor. Do not unduly delay issuance of the report awaiting the contractor's response.

5-1214 ACO Processing of the Report

a. Upon receipt of the report, the ACO will provide a copy to the contractor and allow 30 days or a reasonable extension for submission of its written response. If no significant deficiencies are identified, the ACO will notify the contractor in writing in a timely manner (DFARS 215.811-70).

b. If the contractor agrees with the report findings and recommendations, the contractor should, within 60 days of receipt of the initial ACO notification, correct any identified system deficiencies or submit a corrective action plan showing milestones and actions leading to elimination of the deficiencies. If the contractor disagrees with the report findings and recommendations, the contractor's response should contain the rationale for each area of disagreement (DFARS 215.811-70).

c. The ACO, in consultation with the auditor, will evaluate the contractor's response and determine if: (1) the estimating system contains deficiencies needing correction; (2) any deficiencies are significant enough to warrant disapproval of all or part of the contractor's estimating system; or (3) any proposed corrective actions are adequate to correct the deficiency. When recommending disapproval of portions of an estimating system, identify specific portions that should be disapproved. This will direct attention toward the significant deficiencies

cies as well as inform the ACO which portion should not be relied upon.

d. The ACO will notify the contractor and the auditor of his/her determination and, if appropriate, of the government's intent to disapprove all or a selected part of the system. The notice will list the cost elements it covers and identify any deficiencies requiring correction. The notice will also require the contractor to make correction or submit a corrective action plan within 45 days showing proposed milestones and actions related to all identified deficiencies (DFARS 215.811-70).

5-1215 Monitoring and Follow-up

a. The auditor and ACO will monitor the contractor's progress toward correction of deficiencies. In addition, a follow-up audit will be performed to ascertain the status of the corrective action plan and to reevaluate the significance of any uncorrected significant deficiencies. Since all reported deficiencies require follow-up, make the necessary follow-up within six months of the report issuance date to determine if the contractor has corrected the deficiencies. This period may be adjusted to allow for such factors as the significance of the deficiencies, volume of proposal activity, and realistic time frames for implementing corrective action. When a follow-up audit is not expected to be performed within six months, the auditor should indicate in the report why the follow-up audit has been deferred and the anticipated time frame when the review will be performed.

b. The follow-up audit should include steps to determine that the proposed corrective actions are adequate to correct any deficiencies, including those reported in flash audit reports issued after the system survey report date (see 9-310), as well as to determine that the contractor is complying with its corrective action plan. However, if there is an insignificant amount of proposal activity, the portion of the follow-up to determine contractor compliance with its corrective action plan may be deferred—but the report should note the limited scope. Compliance should then be evaluated during

another follow-up audit. If required, request technical specialist assistance.

c. If the contractor fails to make adequate progress toward corrective action, recommend that the ACO take action to ensure the contractor corrects the deficiencies. Actions for the ACO to consider include reducing or suspending progress payments per FAR 32.503-6 and/or recommending against the award of potential contracts (DFARS 215.811-70).

d. Issue a new report advising recipients of the original report on the status of the corrective actions. Include a description of the deficiency, status of corrective action, and status of any prior recommendation to disapprove portions of, or an entire, estimating system. Also, include the current opinion on the effectiveness of the estimating system with any recommendations to disapprove portions or the entire system. This new report should reference the previous report(s). If necessary, the report will request the assistance of procurement and/or contract administration activities to obtain contractor implementation of survey recommendations. If, as a result of estimating deficiencies, the contracting officer has lowered the threshold for requesting field pricing support (see 9-102.3), recommend that the threshold be raised if the follow-up work reveals that the deficiencies have been corrected. If the deficiencies were not corrected, recommend that the contracting officer take appropriate steps to stimulate contractor corrective action (see 5-1214).

e. If a follow-up audit discloses a significant estimating system deficiency not previously reported, it should be included in the follow-up report.

5-1216 Continuous Evaluation of Estimating Systems

a. Between estimating system surveys, auditors and technical specialists should carefully analyze exceptions taken to contractor estimates which support submitted price proposals. Make arrangements through the ACO for technical personnel to notify the auditor of estimating system deficiencies found during technical evaluations. Also, evaluate conditions attributable to estimating deficiencies dis-

closed during postaward audits and issue an estimating system deficiency flash report (see 9-310c), if appropriate.

b. When the report on an estimating system survey recommends disapproval of the system in whole or part, subsequent proposal audit reports should disclose the recommendation to disapprove the system. For any significant estimating system deficiency, disclose the cost impact where possible in subsequent proposal audit reports. These disclosures should continue until the deficiencies are resolved (DFARS 215.811-70). This also applies to significant estimating system deficiencies discovered during price proposal audits (9-310), estimating system survey follow-up audits (5-1215), and postaward audits (14-120.7d). In addition to questioning any inappropriate proposed costs resulting from estimating deficiencies, consider the following actions to improve the likelihood that the deficiencies will be corrected:

- (1) When an estimating system deficiency exists that has only a minor impact on the adequacy of the proposal, qualify the audit report relative to the acceptability of the cost or pricing data.
- (2) When an estimating system deficiency exists having a material impact on the adequacy of the proposal, consider the above, plus the following actions. (Pursue those actions considered most appropriate in the circumstances.)

- Recommend that the contracting officer return the proposal to the contractor, and allow the contractor additional time to correct the deficiency and submit a corrected proposal (DFARS 215.811-70).

- Recommend that the contracting officer consider another type of contract, e.g., a FPIF instead of a FFP contract (DFARS 215.811-70).

- Recommend that the contracting officer use additional cost analysis techniques (as described in the Armed Services Pricing Manual) to determine the reasonableness of the cost element(s) affected by the deficiency (DFARS 15.811-70).

- Recommend that the contracting officer segregate the questionable areas as a cost reimbursable line item in any awarded contract (DFARS 215.811-70).

- Recommend that some profit or fee adjustment be made in consideration of the system deficiency. This could be accomplished by a direct reduction to the profit objective that would normally be considered based on the weighted guidelines calculation (DFARS 215.811-70).

- Recommend that the contracting officer include a contract clause that provides for adjustment of the contract amount after award (DFARS 215.811-70).

- (3) When a significant deficiency exists that prevents the auditor from measuring the impact, or the impact is so significant that the estimates are not acceptable as a basis for negotiating a fair and reasonable price:

- In addition to pursuing the appropriate steps identified above, issue an adverse opinion as provided by 9-209.3.

c. Cost Accounting Standard 401, "Consistency in Estimating, Accumulating and Reporting Costs," was established to: (1) make the cost accounting practices used by a contractor in estimating costs consistent with its practices for accumulating and reporting costs during contract performance and (2) provide a basis for comparing estimated to actual costs. Use the guidance in Chapter 8 to determine if contractor estimating systems comply with CAS 401 requirements.

5-1300 Section 8 — Participation on Joint System Review Teams

5-1301 Introduction

This section provides guidance as a participant on a joint system review team. As appropriate, the guidance in 9-1300 also applies. Guidance for the auditor on the joint estimating system team is stated in 5-1200.

5-1302 Purchasing and Subcontracting System Reviews

5-1302.1 Introduction

Basic audit requirements in Chapter 6 provide for the review of the operating effectiveness and transactions of a contractor's purchasing and related departments as an integral and necessary part of the audit of purchased material and service costs. When contractor purchasing system reviews (CPSRs) are regularly performed at a contractor location (see 5-1302.2), the auditor should rely upon this work to the maximum extent feasible in establishing the extent of audit coverage to be undertaken in this area. See 5-1302.4 for guidance on the effect of a CPSR on the performance of audits.

5-1302.2 Contractor Purchasing System Review (CPSR)

a. FAR 44.302 requires a CPSR to be made for each contractor whose sales to the government, using other than sealed bid procedures, are expected to exceed \$10 million during the next 12-months. Such sales include prime contracts, subcontracts under government prime contracts, and modifications (except when the negotiated price is based on established catalog or market prices of commercial items sold in substantial quantities to the general public, or is set by law or regulation). A CPSR is to be conducted by the cognizant contract administration agency at least every three years for contractors that meet these requirements. The detailed procedures for conducting initial, subsequent, special, and follow-up CPSRs are in DFARS 244.3 and FAR 44.3. These reviews form the basis for the administrative contracting officer (ACO) to grant, continue, withhold, or withdraw

approval of a contractor's purchasing system.

b. The ACO is responsible for reviewing the contractor's purchasing system. Members of other organizations, including DCAA, may participate in a review conducted under the ACO's authority, but are not to conduct separate reviews of a contractor's purchasing system. If a problem appears to exist, DCAA may recommend to the ACO that an additional review be performed.

c. CPSRs are conducted by teams under the direction of a purchasing system analyst (PSA) assigned by the local or regional contract administration office. The PSA is responsible for accomplishing the CPSR and conducting surveillance reviews. The review team consists of PSAs, the auditor, technical personnel, and other representatives of the ACO. The team captain, normally the senior PSA, will devise the overall review program, make assignments to the individual team members, and coordinate and monitor accomplishments. He/she is also responsible for the preparation and signing of the CPSR report, which is transmitted to the ACO after review by the appropriate CPSR Board. It is the ACO's responsibility to review the recommendations in the CPSR report to determine the appropriate action to be taken to correct any deficiencies and to so advise the contractor.

5-1302.3 Auditor Participation on CPSR Teams

a. Coordination with the PSA. Pursuant to DFARS Supplement Appendix C, the cognizant audit office will appoint an auditor to participate as a team member on initial and subsequent CPSRs or in the continuing surveillance process if used in lieu of a subsequent CPSR. Since the auditor and PSA have related responsibilities, it is imperative that they coordinate and correlate their activities to avoid duplication. The review program should be sufficient in scope to be responsive to the needs of both procurement and audit. The CPSR should make full use of day-to-day work performed by

the auditor as an integral part of the contract audit mission. Maximum use should be made of the auditor's past reviews and evaluations, and results of other audit work which bear upon the effectiveness of the contractor's purchasing system. See 4-1000 for documentation requirements when relying upon such work.

b. Auditor's Role. The auditor will be responsible for the timely performance of those areas specifically assigned by the CPSR team captain.

c. Auditor Performance and Supervision. The auditor will be responsible for the preparation and execution of detailed audit programs for all areas assigned by the team captain. Technical direction will be provided by an audit supervisor. The team captain will correlate the efforts and monitor the accomplishments of the auditor and other team members to the extent necessary for effective coordination of the overall review. During the review, the auditor should discuss audit findings with the contractor in accordance with 4-300. After the auditor's findings and recommendations are developed, they will be reviewed with the audit supervisor and furnished in draft form to the team captain prior to completion of the in-plant effort of the CPSR team, to enable the team captain to conduct the exit conference with the contractor.

d. Reports and Working Papers. The FAO will retain the detailed working papers covering DCAA's part of the review, and submit a complete written report to the team captain setting forth the findings and recommendations in such form and detail as required for the survey report. The auditor's report will be formally issued by the appropriate audit office as soon as possible after the exit conference with the contractor. The team captain will also be provided with any summary schedules and/or copies of working papers required for consolidation of statistical data or as additional supporting documentation for the survey file.

e. Differences Between Audit and ACO Personnel. Differences between the auditor and PSA, or other ACO personnel, with respect to the delineation of responsibilities, policies, procedures, and other

requirements related to the CPSR which cannot be resolved locally will be referred to the regional office. The regional office should also be informed of any differences between the auditor and the team captain relating to audit findings, conclusions, and recommendations.

5-1302.4 Effect of CPSR on Performance of Audits

a. The auditor should coordinate and seek agreement from the ACO and PSA whenever a review of an area affecting the CPSR is contemplated. At contractor locations where CPSRs are regularly performed, the auditor should obtain copies of reports and memorandums issued by the PSA and the ACO. Such items include the CPSR and final summary reports and notifications relating to the approval of the contractor's purchasing system. Based upon DCAA's prior participation in the CPSR and a review of these reports and documents, the auditor will determine the extent to which the work performed under the CPSR meets the audit objectives established in the functional areas enumerated in 6-300 for purchased material and service costs. See 4-1000 for documentation requirements when relying upon the work of others.

b. Where the scope of coverage in the CPSR is considered sufficient to support a conclusion that the policies, administrative procedures, and control procedures in a related functional area are well defined, reasonable in concept, and effectively implemented, the audit program need provide for only minimum substantive testing. When the policies and procedures are not adequate, the audit program should provide for increased substantive testing. Perform substantive testing and verification of individual transactions in the functional area commensurate with the degree of reliability that can be placed on the control procedures. In developing tests of transactions, the auditor should consider the items and periods covered by the CPSR and not duplicate this work.

c. Where a current evaluation of a contractor's purchasing system is needed for audit purposes and a CPSR has not been recently performed, the auditor should coordinate this need with the

ACO and should give due consideration to the timing and scheduling of the next CPSR in planning an audit of purchased material and service costs.

d. PCOs may make requests to the auditor for information pertaining to the adequacy of the contractor's purchasing system even though FAR 44.302 does not require a CPSR at the contractor's location. After appropriate coordination with the cognizant ACO, auditors will be responsive to such requests. The results of recent activity or functional surveys or other audits can serve as the basis for the auditor's reply. However, if the request from a PCO is in effect a request for performance of a CPSR as contemplated by FAR/DFARS 44.3, the auditor will refer such request to the cognizant ACO.

5-1303 Contractor Insurance/Pension Review Program

Basic audit requirements for the review and evaluation of indirect costs are found in 6-600, with additional coverage of insurance and pension costs in 7-500 and 7-600 respectively. DFARS 242-73 sets forth the requirements (primarily directed at contract administration) for conducting a Contractor Insurance/Pension Review (CIPR). When the auditor participates in a CIPR, appropriate consideration will be accorded to data developed during previous audits of these areas in establishing the scope of audit effort. Conversely, the results of the CIPR should be fully integrated in planning the coverage of future reviews of pension and insurance costs. See 4-1000 for documentation requirements when relying upon such work.

5-1303.1 Insurance/Pension Team Reviews

a. CIPRs are currently performed on a formal basis under the leadership of Defense Contract Management Command (DCMC). Section 28.3 of DLA Manual 8105.1 provides for a major review of the insurance and pension programs of contractors whose annual government sales on negotiated prime contracts and subcontracts issued under government prime contracts are expected to exceed \$10 million. A "major review"

consists of a thorough evaluation of a contractor's corporate insurance program and pension plan, including policies, procedures, practices and costs, to determine whether they are in compliance with FAR provisions and pertinent contract clauses.

b. Reviews may also be made of the insurance and pension programs of those contractors that do not meet the criteria established for a major review. These reviews may be performed when special insurance or pension problems require resolution and may cover such areas as insurance on government property, insurance under facilities contracts, reasonableness and propriety of group insurance reserves, and recognition of unrealized appreciation of assets in contractor pension trusts. In this connection, FAO managers, based on vulnerability/risk assessment, should identify contractor locations (1) where the \$10 million thresholds are not met but where CIPRs are still necessary, and (2) where more frequent than biennial CIPRs are necessary. FAO managers should then submit a request to the appropriate DCMD CIPR branch chief in time for his/her consideration in developing the initial and updated CIPR schedules.

c. The ACO is responsible for notifying the contractor of pending insurance and pension reviews and for arranging for the contractor to furnish information required, such as a schedule of insurance coverage, copies of pension plans, and related cost information. Recent revisions to DLA Manuals 8105.1 and 8105.3 require that cognizant DCAA Regions be sent a copy of the DLA CIPR review schedules for each fiscal year by 15 September and an update to the schedule by the following 15 April. DLAM 8105.3 has been further revised to require that the Insurance Branch Chief write to the cognizant DCAA field audit office and ACO, requesting DCAA participation in the CIPR. A designated regional representative should meet with DCMD specialists to verify the schedule.

d. To ensure timely and responsive DCAA participation in CIPRs, the Regional Special Programs Office should:

- (1) Obtain and maintain a current schedule of DCMD CIPRs.

- (2) Meet with DCMD specialists to verify the CIPR schedule and to ensure that DCAA participation is planned and requested.
- (3) Notify FAOs of scheduled CIPRs and their expected participation in the reviews.
- (4) Notify Headquarters, PCD if any FAO is unable to participate in a scheduled CIPR.
- (5) Establish procedures for monitoring the progress of scheduled reviews.

e. The FAO should notify the ACO if it is aware of any contractor who meets the DFARS requirements for a CIPR but has been excluded from the DCMD schedule of planned CIPRs.

f. Reviews are conducted by joint teams under the direction of a DCMD Insurance/Pension Specialist (I/PS). The team will normally consist of the I/PS, the cognizant auditor, and other specialists required in the circumstances. The I/PS serves as team captain and is responsible for determining the overall review scope, making assignments to the individual team members, developing report comments, findings, and recommendations, and issuing the report on the CIPR. The report is addressed to the cognizant ACO, with a copy furnished the auditor. Upon receipt of the I/PS's report, the ACO is then responsible for transmitting it to the contractor for reply.

5-1303.2 Auditor Participation on CIPR Teams

CIPRs will be performed at contractor locations by time schedules to be established by DCMDs. When a field audit office receives advice of a scheduled CIPR, one auditor will be assigned to participate as a team member, regardless of the size of the team. If the scheduled date cannot be met because of other urgent priorities, the DCMD office should be advised accordingly and an alternative date suggested. In view of the interrelationship of auditor, ACO and I/PS responsibilities in the area of insurance and pensions, efforts must be coordinated very carefully to avoid duplication. While the scope of the auditor's program should be responsive to the needs of the ACO and the I/PS, it should

also reflect due consideration for previous audit experience with respect to these costs.

a. The designated DCAA auditor will participate as a member of the team, providing advice and information in a separate report to the CIPR team captain based on the analysis of the contractor's books, accounting records, and procedures. As a minimum, DCAA participation in the performance of a CIPR should include the following:

- (1) Meet with the DCMD CIPR team members before commencing field work to clearly establish the effort DCAA will be performing and milestones to accomplish the effort. To ensure that all necessary audit work is performed during the CIPR, the scope of the review should be established and coordinated with the CIPR team captain prior to the beginning of the on-site review. In addition, there should be a documented understanding between the team captain and the DCAA team member as to review responsibilities. To accomplish this, the auditor participating in CIPRs should identify those audit steps in the DCAA standard pension and insurance audit programs that should be covered to satisfy audit needs. After identifying the necessary steps, the auditor should coordinate with the team captain to determine which team member will perform each step. While specific team responsibilities may vary, the auditor's responsibilities will generally include verification of insurance/pension cost to the contractor's books and records and an evaluation of the allocability and reasonableness of the claimed cost. Reliance should be placed on the work of other team member specialists to the extent appropriate in fulfilling these responsibilities.
- (2) Attend both entrance and exit conferences with the contractor.
- (3) Elevate to the regional audit manager any differences with the CIPR team captain with respect to the delineation of responsibilities, pol-

icies, procedures, and other issues which cannot be resolved locally by the ACO and FAO management. The RSPM should also be notified of coordination problems.

- (4) Issue a report to the CIPR team captain detailing the findings and recommendations of the DCAA review.

b. Auditor performance and supervision will be accomplished in accordance with 5-1302.3c.

c. Reports and working papers will be prepared and processed in accordance with 5-1302.3d.

5-1303.3 Effect of the CIPR on Subsequent Audits

a. The results of CIPRs are an important factor in determining the extent to which insurance and pensions are given audit coverage under Chapter 6, 7-500, and 7-600. The auditor should maintain appropriate follow-up on prior CIPR findings and recommendations (see 14-504). To ensure the most effective use of resources, the results of the combined team effort should be the only formal review of insurance and pension costs for the contractor's fiscal years covered by the review. To accomplish this, all required audit effort concerning insurance and pension costs for the fiscal years covered should be accomplished during the CIPR (see 5-1303.2(a)(1)).

(1) When the CIPR discloses that the contractor's insurance and pension programs are reasonable and effectively maintained, and assuming no significant change in conditions since the previous CIPR, the audit program will be revised to reflect the findings of the CIPR. Conversely, when significant deficiencies had been disclosed by a previous CIPR, the auditor should verify corrective action taken. If corrective action has not been accomplished, the auditor should ascertain the reason(s) for inaction. The ACO should be advised and the audit scope appropriately adjusted.

(2) If the scope of the previous CIPR was limited and did not provide an adequate basis for an audit conclusion as to the allowability of the costs generated by the insurance and pension areas in their entirety, the audit program should provide for the additional review necessary to accomplish such objective. If circumstances indicate that additional review of the contractor's insurance or pension program is required, the ACO should be requested to initiate the review in accordance with DFARS 242.7301(d) (see 5-1303.1b).

b. In establishing the time frame for cyclic audit coverage of insurance and pension costs, the auditor should contact the I/PS to ascertain the timing of future CIPRs. The planning for audit coverage of insurance and pension costs should be coordinated with the scheduled CIPRs.

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CHAPTER 6**6-000 INCURRED COSTS AUDIT PROCEDURES****6-001 Scope of Chapter**

This chapter presents general guidance on auditing costs incurred under the broad types of contracts and functional areas of cost incurrence. Chapter 5 provides guidance on systems and internal control structure reviews; Chapter 7 provides more specific guidance on auditing selected areas of cost; and Chapter 8 covers specific requirements of the Cost Accounting Standard Board's rules, regulations and standards. Section 6-100 includes guidance on the integration of incurred cost audit procedures required by Chapters 1 through 8.

6-100 Section 1 — Introduction to Incurred Cost Audit Objectives**6-101 Introduction**

a. This section provides introductory guidance on the contract audit objectives and approach for incurred costs, including general considerations that apply under all types of contracts and for all cost categories.

b. In conducting incurred cost audits, observe any operations security (OPSEC) measures required by current DoD contracts or requests for proposals, in accordance with 3-205.

6-102 Audit Objectives and Approach for Incurred Costs**6-102.1 Audit Objectives**

The auditor's primary objective is to examine the contractor's cost representations, in whatever form they may be presented (such as interim and final public vouchers, progress payments, incurred cost submissions, termination claims and final overhead claims), and to express an opinion as to whether such incurred costs are reasonable, applicable to the contract, determined under generally accepted accounting principles and cost accounting standards applicable in

the circumstances, and not prohibited by the contract, by statute or regulation, or by previous agreement with, or decision of, the contracting officer. In addition, the auditor must determine whether the accounting system remains adequate for subsequent cost determinations which may be required for current or future contracts. The discovery of fraud or other unlawful activity is not the primary audit objective; however, the audit work should be designed to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objective. If illegal activity is suspected, the circumstances should be reported in accordance with 4-700.

6-102.2 Audit Approach

a. Incurred cost audits are usually performed on a contractor-wide basis. This approach recognizes the efficiency of addressing the adequacy of management and financial systems and controls combined with transaction testing across all business activities as opposed to contract by contract audits. Only in certain low-risk situations would DCAA audit individual contracts, such as an audit of a small-dollar contract at a multi-million dollar corporation where the small contract represented the company's only business with the government.

b. For major contractors and contractors with significant negotiated firm-fixed price contracts, reviews of relevant accounting and management systems will be performed on a cyclical basis and form the foundation for determining the nature and extent of transaction testing necessary on individual incurred cost audits. See Chapter 5 for guidance on reviews of contractor's internal controls.

c. For non-major contractors, separate audits and reports on individual contractor accounting and management systems may not be necessary. An understanding of the contractor's internal control structure may be gained at the time of the final overhead audit or during individual contract audits. The auditor's understanding

of the internal control structure gained from these audits should be documented in the permanent file. (See 5-111 for further guidance on reviewing internal controls at nonmajor contractors.)

d. Regardless of the audit approach, in all audits emphasis will be on determining the overall acceptability of the contractor's claimed costs with respect to (1) reasonableness of nature and amount; (2) allocability and capability of measurement by the application of duly promulgated Cost Accounting Standards and generally accepted accounting principles and practices appropriate to the particular circumstances; and (3) compliance with applicable cost limitations or exclusions as stated in the contract or the FAR.

6-103 Audit Scope

a. The procedures and audit guidance presented in this chapter are applicable to all contract audits. However, the auditor must exercise professional judgment in selecting which procedures and techniques are appropriate in the circumstances. The scope of work necessary is a matter of audit judgment considering the contract auditing and reporting standards in the context of a variety of factors which might be involved in a particular audit. These factors are discussed in Chapter 3. Additional considerations are the Mandatory Annual Audit Requirements which are intended to assist in achieving the appropriate scope of audit (see 6-104).

b. The auditor will normally integrate the audit procedures required by Chapters 6, 7, and 8 with reviews of the contractor's policies, procedures, internal controls, and accounting and management systems required by Chapter 5. Also, the government auditing standards and other procedures covered by Chapters 1 through 4 apply to the audit of incurred costs.

6-104 Mandatory Annual Audit Requirements

Mandatory Annual Audit Requirements (MAARs) are basic criteria and procedures necessary to comply with gov-

ernment auditing standards in the contract audit environment. The MAARs vary greatly in purpose, type of transaction under review, and time frame of accomplishment (see 6-104.1). Considerations which affect the applicability or extent of effort necessary to satisfy MAARs in particular cases are discussed in 6-104.2 and in 6-1S1.

6-104.1 Classes of MAARs

a. As shown in 6-1S1, the MAARs may be grouped as Permanent File Updates, Reconciliations, Transaction Tests, and Special Purpose.

b. Permanent File Updates are accomplished on a continuous basis as audits are performed and are not necessarily associated with a single contractor fiscal year or exclusively with incurred cost audit. By contrast, Reconciliations are a preliminary step in the audit of incurred costs. Transaction Tests are always historical, but need not be deferred until the year has ended. Special Purpose MAARs always have concurrent implications. For example, the composition, though not the final value, of the various indirect allocation bases (MAAR 18) may be established well in advance of the start of the fiscal year.

6-104.2 Accomplishment of MAARs

a. Major Contractors. MAARs will be performed at all major contractors except when such work will fulfill no useful current or future need or the contractor has no costs claimed in one or more cost elements related to specific MAARs. The performance of MAARs should not be omitted on the basis of materiality; however, the extent of audit work to complete each MAAR must be adjusted to reflect appropriate judgment of risk and significance. Appropriate considerations include: (1) amount of costs claimed, (2) results of prior audits, and (3) adequacy of internal controls. A MAARs Control Log (DCAA Form 7640-24b) is required to provide summary documentation of the MAARs coverage.

b. Nonmajor contractors. MAARs performance at nonmajor contractors is discretionary depending on their applicability and materiality. Unlike major contractors, there is no presumption that all

MAARs are material. Decisions concerning MAARs performance should be based on sound judgment about significance of claimed amounts and known risk. The reasons underlying a decision to eliminate a MAAR must be documented. Properly completed MAARs Control Logs normally satisfy this requirement. The MAARs control log applicable to contractors having between \$5 and \$40 million current contractor fiscal year (CCFY) dollars is DCAA Form 7640-24a. The log applicable to contractors having under \$5 million CCFY dollars is DCAA Form 7640-24c.

6-104.3 Audit Management Considerations

Because of their status as core requirements, the MAARs provide a convenient framework for incurred cost audit management. Effective audit planning must include verification of the existence of prime costs (direct labor and direct materials, MAAR 6 and 13, respectively) as they are incurred and must provide for historical coverage of other MAARs. MAARs completion dates are important milestones in monitoring the progress of audits of incurred costs.

6-104.4 Reporting Considerations

When an applicable mandatory annual audit requirement which is considered material in reaching an audit opinion is not accomplished, the audit report will include an appropriate scope of audit qualification (see 10-504.1b). Audit reports will not be qualified for the omission of an inapplicable or immaterial MAAR.

6-105 General Considerations

The following sections of this chapter provide audit guidance on various types

of contracts and categories of direct and indirect costs. However, several overall factors must be considered in every phase of incurred cost audit work. Among the more significant points requiring alertness and special emphasis in all audit areas are the following:

a. Contract provisions which specify unallowable costs or cost limitations. Consideration must be given to the costs properly assignable to each contract (see 3-202 for guidance on briefing contract provisions). For example, losses on one contract are not allowable under another contract. Instances of contractor violation of the requirement to properly assign costs to contracts should be reviewed to determine if the practice is reportable under the provisions of 4-700 as one involving suspected fraud or other unlawful activities.

b. Contracts for major defense equipment which provide for recovery of a pro rata share of nonrecurring costs when the contractor sells such equipment to buyers outside the U.S. Government (see 5-203).

c. Charges or credits of an unusual nature, whether or not recorded on the contractor's records.

d. Proper reduction of contract costs for material returns, transfers, credits and discounts, and for income items which can more properly be considered as a reduction of costs. The determination to apply such credits in the current or in prior accounting periods will depend upon the period to which the item relates, the significance of the item, and other related factors, including for each period the ratio of government work to other work of the contractor, and the contract types in effect.

Schedule of Mandatory Annual Audit Requirements (MAARs)			
6-1S1 Supplement Number and Title	Classification	Objectives	Purpose
1. Update Internal Control Audit Planning Summary	Permanent File Update	Prepare/update internal control audit planning summary and evaluate changes in contractor's internal controls.	Determine the extent of reliance that can be placed on the internal controls for contact costs and the need for and extent of substantive testing that may be required based on the observed strengths or weaknesses of contractor systems.
2. Contract Cost Analysis and Reconciliation to Books	Reconciliation	Review summaries of the contractor's total annual contract costs by major cost element (material, subcontracts, intracompany charges and credits, etc.) and verify that the auditable contract costs reconcile to contractor accounting records by cost element (typically using work- in-process or other contract control accounts in the general ledger).	To provide an overview and order-of-magnitude frame of reference for direction of audit effort and other audit planning/performance considerations, and to verify that the auditable costs claimed or to be claimed on Government contracts tie in to the amounts produced by the accounting system in the contractor's official books and records.
3. Permanent Files	Permanent File Update	Maintain/update permanent files for new or changed contractor organizations, operations, policies, procedures, internal controls, and accounting methods that influence the nature, level, and accounting treatment of costs being charged or to be charged to Government contracts.	To provide and efficient and effective repository of current audit information. Permanent file maintenance should help identify the need for further audit reviews and analysis and help in determining the accounting methods that influence the nature, level, and extent of further testing required in specific cost accounts, functions, operations, and departments.
			Reference 5-100 6-609.1 4-405.1b

Schedule of Mandatory Annual Audit Requirements (MAARs)				
6-1S1 Supplement Number and Title	Classification	Objectives	Purpose	Reference
4. Tax Returns and Financial Statements	Reconciliation	Review applicable tax returns and financial statements of the contractor.	To highlight possible areas requiring further attention and/or to reduce the extent of DCAA audit effort that might otherwise be required.	3-104.16c
5. General Ledger, Trail Balance, Income and/or Credit Adjustments	Special Purpose	Review the contractor's general ledger, trial balance, and other income/accounting adjustments (for example, unusual and/or sensitive journal entries).	To help identify any income and credits which the Government may be entitled to obtain or share, and to evaluate the exclusion of any adjustments not reflected by the contractor in Government contract costs.	6-608.2d(5) 6-608.3b(1)
6. Labor Floor Checks or Interviews	Special Purpose (concurrent)	Perform floor checks, interviews, and/or other physical observations and related analysis of employee timekeeping.	To test the reliability of employee time records, that employees are actually at work, that they are performing in assigned job classifications, and that time is charged to the proper cost objective.	6-604.2
7. Changes in Direct/Indirect Charging	Permanent File Update	Review changes in procedures and practices for direct/indirect time charging of contractor employees for consistency with generally accepted accounting principles, the applicable cost principles per contracts, and any applicable Cost Accounting Standards requirements.	To verify that changes in direct/indirect charging practices do not have the effect of improperly shifting costs among cost objectives or circumventing cost targets or ceilings of certain contracts or other significant cost categories.	6-604.1
8. Comparative Analysis-Sensitive Labor Account	Special Purpose	Perform comparative analysis of sensitive labor accounts.	To identify for further review any sensitive labor changes (for example, indirect charging by direct labor employees) that vary significantly from the prior period and/or budgetary estimates.	6-404.6b(5)

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Schedule of Mandatory Annual Audit Requirements (MAARs)			
6-1S1 Supplement Number and Title	Classification	Objectives	Purpose
9. Payroll/Labor Distribution Reconciliation and Tracing	Reconciliation	Review the contractor's labor cost distribution.	To test overall integrity of labor cost records at the general ledger and cost ledger levels and to reconcile payroll accruals and disbursements, making sure that distribution entries trace to and from the cost accumulation records.
10. Labor Adjusting Entries and Exception Reports	Transaction Test	Review adjusting journal entries and exception reports for labor costs.	To identify adjustments and/or exceptions that require further audit analysis and explanation.
11. Purchases Adjusting Entries and Exception Reports	Transaction Test	Review adjusting journal entries and exception reports for costs of purchased services and material (including subcontract costs and intracompany charges).	To identify adjustments and/or exceptions that require further audit analysis and/or explanation.
12. Auditable Subcontracts/ Audit Audits	Special Purpose	Review auditable type subcontracts and intracompany orders issued by the contractor under auditable type Government contracts and subcontracts, and request any needed independent assist audits.	To protect the Government's interests concerning the ensuing costs.
13. Purchases Existence and Consumption	Special Purpose (partially concurrent)	Make physical observations and/or inquire in addition to documentation verification of contract changes for purchased materials and services.	To test that materials were in fact received (exist or were consumed) and that services were in fact performed.
14. Pools/Bases Reconciliation to Books	Reconciliation	Trace claimed pools and bases to accounting records	To determine that the claimed indirect cost pools and allocation bases under Government contracts reconcile to amounts in the contractor's official books and records.
			Reference 6-406.2a(6) 6-306.3a(1) 6-305.3a(1) 6-801.1g 6-802.4a 6-305.3a(2) 6-609.2

Schedule of Mandatory Annual Audit Requirements (MAARs)				
6-1S1 Supplement Number and Title	Classification	Objectives	Purpose	Reference
15. Indirect Cost Comparison with prior Years and Budgets	Reconciliation	Review the current year's indirect cost accounts and prior years' costs and budgetary estimates.	To identify changes in cost accounting practices, reclassifications of costs, and areas with substantial increases or decreases in cost incurrence that require further audit analysis and/or explanation.	6-608.2c(2)
16. Indirect Account Analysis	Transaction Test	Review selected indirect cost accounts or transactions such as sensitive accounts, new accounts, accounts with large variances, etc.	To obtain sufficient evidence to support an opinion on the allowability, allocability, and reasonableness of the costs.	6-608.2
17. IR&D/B&P Compliance	Special Purpose	Review the contractor's independent research and development and bid and proposal costs	To verify for proper classification and compliance with the terms of Government contracts and any related agreements.	7-1500
18. Indirect Allocation Bases	Special Purpose	Review the contractor's indirect cost allocation bases for consistency with generally accepted accounting principles, the applicable cost principles per contracts, and any applicable Cost Accounting Standards requirements.	To assure that allocation bases are equitable for allocation of indirect costs to intermediate and final cost objectives.	6-606.1
19. Indirect Rate Computations	Reconciliation	Review the accuracy of the contractor's rate computations for distributing interim and final indirect costs to intermediate and final cost objectives.	To confirm that contractor's rate computations are accurate for distributing indirect costs to Government contracts.	6-610.1a
20. Indirect Adjusting Entries	Transaction Test	Review adjusting journal entries for indirect costs.	To identify adjustments that require further audit analysis and/or explanation.	6-608.2c(2)

6-200 Section 2 — Special Considerations in Audit of Selected Contract Types

6-201 Introduction

This section states guidance and special considerations in the audit of selected contract types.

6-202 Costs Before Contract Date, After Completion, or Over Contract Amount

This paragraph states guidance for the review of reimbursement vouchers covering precontract costs, costs incurred after completion or delivery dates specified in a contract, or costs incurred in excess of the contract amount.

6-202.1 Basis for Determining Allowability of Precontract Costs

Precontract costs are defined in FAR 31.205-32. Such costs, which otherwise meet the tests of allowability, may be approved for reimbursement by the auditor. If the precontract costs are subject to an advance agreement, the auditor should determine whether the costs incurred meet the conditions of the agreement. However, if there is no advance agreement, the auditor should ascertain whether the precontract costs meet all the tests of FAR 31.205-32 and are allowable to the same extent they would have been allowable if incurred after the effective date of the contract. The auditor should obtain the assistance of the Plant Representative/ACO and, where appropriate, the PCO in reaching this decision whenever necessary to clarify the facts and conditions for incurring precontract costs.

6-202.2 Procedure Where Term of Contract Performance Period is Explicit

A contract may provide that it expires on a specified date, unless terminated before that date, and obligates the contractor to devote a specified level of effort for a stated time period [see FAR 16.306(d)(2) and FAR 52.249-6(a)]. The auditor shall not approve for reimbursement any costs incurred by the contractor subsequent to the expiration date stated

in the contract, or in excess of contract limitations.

6-202.3 Procedure Where Contract Specifies a Completion or Delivered Product

A completion or delivered product specified in a cost-type contract normally commits the contractor to complete and deliver the specified product within the estimated cost. In the event the work cannot be completed within the estimated cost, the government may require more effort without an increase in fee [see FAR 16.306(d)(1)]. Also, under FAR 52.246-6(a), the contracting officer could terminate the contract prior to full expenditure of the estimated cost. However, unless the contract is terminated, or exceeds stated contract limitations, the contractor is normally obligated to continue to perform under the contract up to the estimated total contract cost.

6-202.4 Costs in Excess of Contract Amount

The auditor will not approve any costs claimed by the contractor in excess of the estimated total amount stipulated in the contract. Such excess costs will be disapproved by the issuance of a DCAA Form 1.

6-203 Credits and Refunds on Cost-Type Contracts

This paragraph states the procedures to be used (1) in adjusting allowable contract costs for applicable credits, and (2) for the collection and disposition of such credits which are refunded by the contractor. Deduction for General Accounting Office notices of exception is covered in 6-909.

6-203.1 General Audit Policy

A complete listing of types of credits is not practicable; however, some examples of miscellaneous income items and other credits are discussed in 6-608.2d(5).

a. It is not anticipated that any major difficulties will ordinarily be encountered

in making the necessary accounting adjustments to allowable contract costs for the applicable credits and refunds discussed in this section. In a few cases, however, because of the timing of disclosure or receipt of these credits, special procedures may be necessary which are discussed in detail in this section.

b. The contractor's accounting procedures should provide for periodic review and the processing of equitable adjustments to operating cost to cover miscellaneous income items and credits, such as wages; unclaimed deposits for tools, safety equipment or clothing; unclaimed payroll deductions for purchases of U.S. Savings Bonds; and unrepresented checks other than payroll. Payment of these funds to the state under escheat laws constitutes an actual expenditure and satisfies the refund requirement. Where no escheat laws are applicable, consideration must be given to the ownership of the credits and unclaimed items to determine whether an adjustment is to be made. The government is not entitled to credits attributable to amounts paid by employees or withheld from their salaries if the amounts were not initially charged either directly or indirectly to the cost of government contracts and, accordingly, not reimbursed by the government. If amounts were initially charged to operations and equitably shared by the government, adjustments should be reflected either in an income account which is deducted from an applicable indirect cost category or else as a deduction directly to the account originally charged. Where a contractor is engaged in work under government flexibly-priced contracts on a relatively consistent basis, the foregoing periodic adjustment procedure should normally result in equitable consideration of these credit items. Where, however, such consistency is not present, consideration should be given to the direct costing of significant credits and refunds to the specific contracts under which they were generated as the best means of ensuring that the government obtains the full benefits to which it is entitled.

c. As an alternate to the adjustment of costs for credits and refunds, the contractor may refund the amount by a check,

drawn to the order of the Treasurer of the United States. This procedure is in fact required when the refund applies to a contract that has been financially settled since, as a condition precedent to final settlement of a contract, the contractor is required to execute an assignment of credits, refunds, and rebates. Such assignment provides that credits, refunds, and rebates, whatever their origin, attributable to contracts which have been financially settled, should be refunded by the contractor to the government by check drawn to the order of the Treasurer of the United States. The refund check, together with the details pertaining to the transactions, shall be submitted by the contractor to the ACO by the provisions in the Assignment of Credits, Refunds, and Rebates.

6-203.2 Processing Adjustments for Credits and Refunds

a. During the period of contract performance, credit adjustments made in the contractor's accounting records as a deduction from reimbursable contract costs will normally be reflected in public vouchers submitted for that same period.

b. In the event the contractor fails to make the necessary deductions from current contract costs for applicable credits or to make refunds therefor, the auditor shall effect recovery by the issuance of DCAA Forms 1 and deduct the amounts from current reimbursement claims.

c. When the credits cannot be recovered by deductions from the public vouchers to which they would normally pertain and the contractor declines to make a refund, the auditor will process a DCAA Form 1 set-off deduction from the public voucher(s) submitted by the contractor under any other cost-reimbursement type contracts under the auditor's cognizance. The DCAA Form 1 should show the contract and appropriation to which the credit is applicable. However, it should be noted that where a contract so provides, public vouchers payable to an assignee may not be subject to reduction or setoff for any indebtedness of the assignor arising independently of the assigned contract.

d. In those cases where the applicable contract is closed and collection of cred-

its cannot be effected by the auditor under any of the procedures in subparagraphs a. through c. above, a report should be made to the ACO. The report will identify the contracts, the amount of the credits, their origin, and state the reasons why recovery cannot be accomplished by the auditor through refund or deduction.

6-203.3 Disposition of Refunds Paid by Checks

The auditor should generally not accept checks from contractors for credits due the government. Contractors should be advised to submit such checks directly to the paying office, with a copy to the ACO, together with a copy of the details comprising the credit, such as the listing prescribed in 6-203.4c., which should agree in total with the amount of the check. Any checks received by the auditor should be transmitted immediately to the ACO together with the required listing.

6-203.4 Special Procedures for Unclaimed Wages, Unclaimed Deposits, and Unpresented Checks

a. Where the balances of unclaimed payroll deductions for U.S. Savings Bonds are insufficient to purchase bonds, Treasury Department instructions permit, but do not require, contractors to transfer the balances to the Treasury Department to be held in custody for the account of the employees concerned. Unless the contractor makes these transfers, such amounts will be included in the cost adjustments described below.

b. Many states have enacted escheat laws governing the disposition of unclaimed wages, unclaimed deposits, and unpresented checks after the expiration of stated periods of time. Escheat laws generally provide for payment of these unclaimed amounts to the state. This subject has resulted in some confusion and several court cases, particularly in regard to disposition of these items where the creditor and debtor are located in different states. It has now been determined, however, that the Federal government is entitled to recover such unclaimed amounts only if (1) they represent sums due to persons or firms whose

last known addresses were in states which do not have escheat laws, and (2) if, in addition, the escheat law of the state in which the contractor is located does not provide for the payment of the amounts to its own (state) account. Accordingly, where the auditor ascertains credits are due the government under the foregoing criteria, he or she will discuss the matter with the contractor and ensure that adjustments or refunds are made by the contractor or that DCAA Forms 1 are issued for the applicable amounts.

c. At the time credit adjustments or refunds are processed, the contractor will prepare and retain separate listings of the former employees entitled to the unclaimed amounts, and of the payees of unpresented checks which are covered by the credit adjustment or refund. The listings must be in sufficient detail to permit audit verification of each named payee in the event claims are made to the government at a later date by virtue of subsequent payments. These lists will be verified by the auditor on a selective test basis as deemed appropriate. Separate lists will be submitted for each category of unclaimed items and for unpresented checks.

d. Subsequent to the government's recovery from contractors for unclaimed wages, unclaimed deposits, and unpresented checks, claims may be made by the persons entitled to such funds. These claims should be presented to the contractor and not to the government, as the latter has no contractual relationship with the claimants.

e. In the case of reimbursements claimed by contractors for any payments made to such persons, a certified invoice, valid receipt of the payee, and any other pertinent information must be submitted with the claim to identify the payment with the applicable item on the listing mentioned in 6-203.4c. In such instances the amounts claimed will be cross-referenced to the public vouchers from which the credit deduction was initially made and, after verification, will be approved by the auditor for reimbursement.

f. In the event that the contract to which the claim relates has been financially settled, the contractor's claim, together with the documentation described

in subparagraph c. above, should be submitted after verification and approval by the auditor, to one of the following as appropriate:

Finance Center, U.S. Army, Attn: FINCS, Indianapolis, Indiana 46249; or U.S. Navy Finance Center, Accounts Receivable and Claims Division, Code FR, Washington, D.C.; or Finance Officer, Air Force Accounting and Finance Center, Symbo. CF, Denver, Colorado; or as required by the department or office that placed the contract.

6-204 Time and Material Contracts

6-204.1 General Policy

a. Time and material (T&M) contracts (which term as used herein includes subcontracts) provide for the procurement of supplies or services on the basis of (1) direct labor hours at specified fixed hourly rates (which rates include direct labor, indirect costs, and profit) and (2) material at cost. Material handling costs may be included in the charge for "material at cost," when it can be demonstrated that they were not included in the overhead factor of the hourly rate to be applied to direct labor.

b. The basic auditing procedures in Chapter 6 will be applied, as appropriate, to audit of time and material contracts. The guidelines of Chapter 9 should be used in the evaluation of proposals for time and material contracts. In addition to the foregoing, the audit program should include the considerations discussed below.

6-204.2 Audit of T&M Labor Costs

a. General. An important prerequisite to the audit of labor (salaries and wages) is a good understanding of the contract clauses relating to the classes of labor and types of operations to which the contractual rates apply. Since the contract labor rates include indirect labor, indirect costs, and profit, only the hours of workers performing labor directly related to the item produced or service rendered will be considered to be direct labor. The basis upon which the direct labor hours are computed and charged must be acceptable and subject to audit verification.

Arbitrary or unsupported allocations of direct labor will not be acceptable.

b. Classes of Labor. Unless otherwise specified in the contract, the direct labor charged by the contractor should include only that which is consistently classified as direct labor with its regularly established practice and is consistent with the labor so classified in the proposal upon which the contract was negotiated.

(1) Wages of personnel such as clerks, material handlers, receiving or shipping personnel, stockroom employees, tool-crib attendants, janitors, maintenance men, packers, contact men, and expeditors, as generally defined within the trade, are not acceptable as direct labor unless specifically authorized in the contract.

(2) The time of partners, officers, or supervisors is not acceptable as direct labor unless specifically authorized in the contract. In such event, the time of the individual must be properly recorded and subject to audit verification.

(3) Where separate rates are not established for the various skill levels, the time of apprentices and learners as a direct charge normally should be limited to the ratio of such time considered in the development of the hourly rate included in the contract. Disproportionate use of lower paid employees will be promptly brought to the attention of the contracting officer.

c. Overtime. Only the hours actually worked are acceptable whether regular or overtime. Overtime hours will not be converted to a larger number of regular hours to compensate for any overtime premium payments, nor will the rates charged for overtime hours be increased unless the contract so provides.

d. Floor Checks. Floor checks will be made to determine that direct employees are actually present and working on the job and that their time is being properly charged. The contractor's system of internal control should provide for such checks. Therefore, the frequency and scope of floor checks performed by the auditor will be determined, in large measure, by the frequency and effectiveness of similar checks performed by the contractor (see 6-400).

6-204.3 Material Costs

The material costs should be audited by the terms of the contract and the procedures in 6-300. While all such procedures are applicable, care should be taken to ascertain, when appropriate, (1) that the method(s) of determining material costs is consistent with the factors included in the determination of labor rates, (2) that all applicable discounts or expense credits have been included, (3) that subcontract billings do not exceed rates for such work regularly agreed upon between the contractor and subcontractor unless specifically authorized by the contracting officer or terms of the contract, and (4) that appropriate accounting (and credit) has been accomplished on unserviceable parts, excess inventory and scrap.

6-205 Technical Service Contracts**6-205.1 Introduction**

Technical service contracts provide for the contractor to furnish personnel and other services for the performance of the work specified in the contract, with reimbursement for such services usually on the basis of:

a. A fixed rate per hour, day, or month for the services of the assigned technician, which sum may vary depending on whether the technician is on domestic or foreign duty. Such fixed rate should normally provide for treatment of nonworking time (i.e. vacations, illnesses, etc.).

b. An allowance for subsistence and housing at either actual costs, if reasonable, or at specified fixed per diem rates, subject to modification when subsistence or quarters are furnished by the government.

c. The cost of transportation to and return from the duty station as well as transportation while at the duty station incident to the performance of the contract. Cost of employee dependents will not be at any additional cost to government.

d. The allowable cost of such other items as are expressly provided for in the contract.

6-205.2 Audit Responsibility

a. Audits will be performed on those contracts that specifically provide for audit determinations or in response to specific requests made by the procuring activity. In some cases, the provisions for audit, or the submission of reimbursement claims for audit, will be limited to certain items as designated under the contract.

b. When audits are required, arrangements for assist audits required to determine the propriety and reasonableness of cost will be the responsibility of the auditor at the prime contract location.

c. When technical service contracts represent substantial values, normal auditing procedures should provide for a determination that the contractors' procedures for costing the performance of the technical services are consistent with the cost objectives considered in negotiating the billing rate. For example, if a staff-month billing rate provides for inclusion of vacation or other leave as properly billable time, amounts for these leave allowances for other direct employees should not be included in the overhead used for determining the staff-month rate and all such leave should be included in the labor base. Further, the overhead expense factor included in the staff-month rate should represent a reasonable offsite rate which will include only those expenses applicable to the offsite operation.

6-205.3 Audit Reports

Reports will be issued in accordance with the applicable section of Chapter 10 and will be fully responsive to the specific requests. In addition, reports should be issued without a request whenever the auditor encounters information which would be of value in the administration of the contract or in the negotiating of contract prices.

6-206 Underruns, etc. on Incentive Contracts

a. In those instances where the actual costs vary widely from the estimated costs which were considered in setting the target cost, the report should contain

specific coverage as to the cost element and reasons, if discernible, for the variance. The following are some of the areas which may cause major deviations between actual and estimated costs.

(1) Changes in the "Make-or-Buy" pattern of major components.

(2) Changes in the cost accounting system including basis for allocation of indirect expenses. If the contractor is required to comply with the Cost Accounting Standards Board's rules, regulations, and standards, the auditor should refer to Chapter 8.

(3) Provision for contingencies which did not materialize such as forecasted increases in the cost of raw materials; anticipated union demands; or anticipated increases in costs of major components and royalties.

(4) Engineering changes which resulted in extraordinary and unanticipated reductions in costs.

(5) Overstatements of important elements of cost during the initial price negotiations due to subsequent develop-

ments which were not foreseen by either the contractor or the government.

(6) Overstatements of important elements of cost due to defective pricing (see 14-100).

b. It is not intended that the auditor make a detailed analysis of the entire amount of the underrun or an evaluation of the adequacy of the initial price negotiations. Audit programs should, however, be designed to bring any items of significance mentioned in the preceding paragraph to light at the earliest practicable time. If the items disclosed have a material effect on the relationship of actual costs to target costs, they should be brought to the attention of the contracting officer. Items which involve apparent defective pricing or indicate a need for voluntary price adjustments will be reported separately as provided in 14-100 and 4-802, respectively. A reference to such reporting will be included in the report on the finalization of price of the incentive type contract; all other matters will be reported in detail as provided in 6-205.3.

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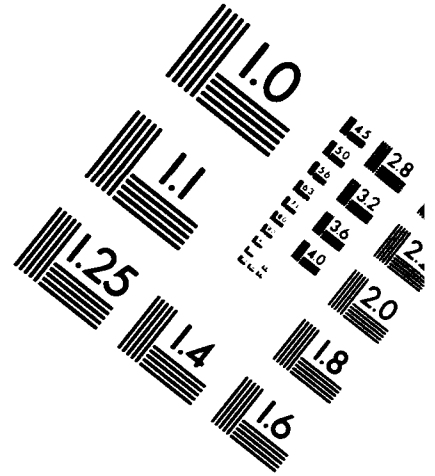
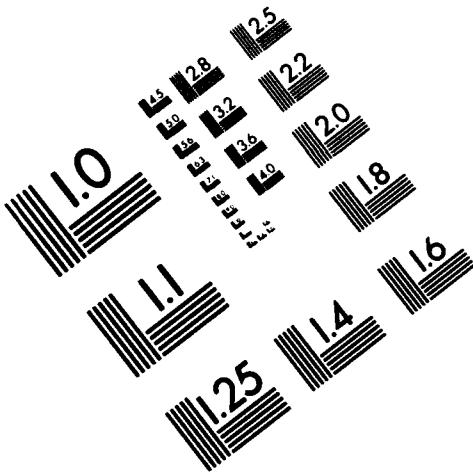




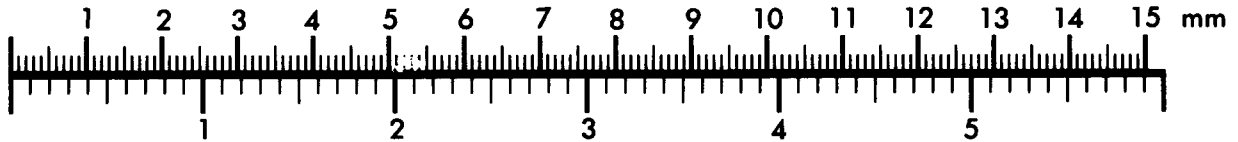
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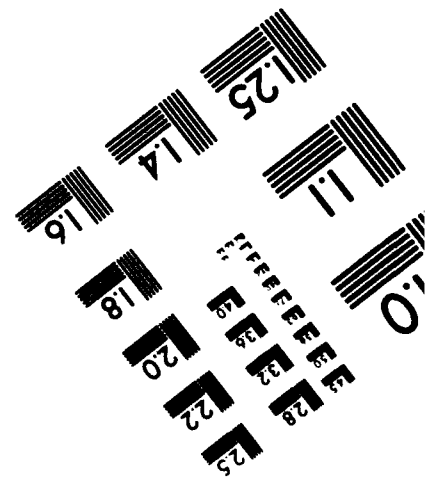
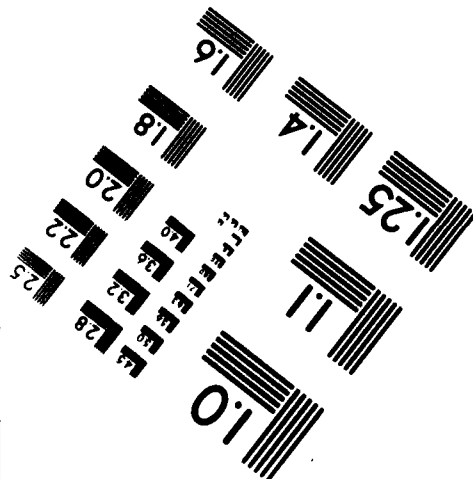
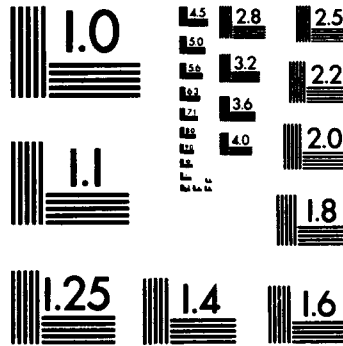
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6-300 Section 3 — Audit of Incurred Material Costs and Purchased Services

6-301 Introduction

This section presents audit guidance and procedures for the review and evaluation of direct and indirect material costs and purchased services. The guidelines relate to the review of the following functional areas: material costs accounting; physical inventories and adjustments; scrap, spoilage, excess, and obsolescence; determination of requirements; make or buy decisions; purchasing and subcontracting; receiving and inspection; storing and issuing; and intracompany transfers.

6-302 Audit Objectives

a. The auditor's examination of transactions and procedures in the functional areas discussed in 6-301 must be sufficient to support an opinion on the allowability, allocability, and reasonableness of costs charged to the contract. In performing this overall test, determine whether the material was:

- (1) needed for the contract
- (2) charged and billed in a reasonable relationship to its use in the manufacturing process
- (3) considered properly for make or buy
- (4) purchased in reasonable quantity
- (5) purchased at a prudent price
- (6) used on the contract
- (7) in compliance with contract terms and CAS (particularly CAS 402 and 411)
- (8) accounted for properly as to initial charge, transfer in or out, and residual value.

b. Also be alert for restraints on competition attributable to a contractor's director(s) having an interest in a supplier or subcontractor (interlocking directorates). Any suspicion of preferential treatment (such as indications of conflicts of interest, unwarranted sole-source purchases, or kickbacks) should be reviewed for possible reporting under 4-700.

c. Reviews in this area can be used to satisfy mandatory annual audit requirements related to the applicable portions of updating the internal control audit

planning summary (No. 1), adjusting entries/exception reports for purchased services and material costs (No. 11), auditable subcontracts/assist audits (No. 12), and the existence/consumption of purchases (No. 13).

6-303 Scope of Audit

a. Many different functional areas comprise contractor Material Management and Accounting Systems (MMAS). Audit objectives and guidelines for each of the major MMAS functional areas are discussed throughout the remainder of this section and in 5-700. Generally, the audit scope will address whether:

- (1) the contractor has established appropriate policies, procedures, and controls
- (2) whether the contractor consistently follows established policies, procedures, and controls
- (3) whether material and related costs are allowable, allocable, and reasonable.

The scope of audit in any of these areas will consider reliance that can be placed on the work of others (4-1000). Particular consideration should be given to adjust, when appropriate, audit scope to give consideration for adequate contractor demonstrations and audits performed under DFARS 242.72 or 244.

b. Chapter 5 presents guidance for evaluating a contractor's policies, procedures, and related internal controls. The government expects all contractors to have adequate controls to ensure system and data integrity. The auditor's assessment of the effectiveness of these controls (control risk) will influence the extent of testing and verification necessary to express an opinion on the allowability of material costs charged to Government contracts.

c. Major considerations affecting the extent of the testing and verification of material costs include:

- (1) the significance of the dollar amount of material costs
- (2) the extent of prior audit experience with the contractor involving the same or similar items

(3) the reliability and acceptability of the contractor's management policies, procedures, and system of internal controls

(4) the contractor's use of electronic data processing

(5) the nature, extent, and results of any reviews accomplished by other government activities.

d. The specific scope of audit for testing and verifying material costs is a matter for judgment in the individual circumstances, subject to established DCAA policy (e.g., the use of statistical sampling techniques). DFARS 242.242-7004 requires contractors to provide sufficient evidence of compliance to the MMAS standards when meeting the thresholds to demonstrate. This contractor testing will significantly affect the scope of the audit based on the guidance in CAM 4-1000.

e. When material costs are significant, consider the following when designing substantive tests:

(1) Audit of all large purchases or system areas in which control risk is assessed as high.

(2) Audit of all sensitive purchases, such as scarce materials, sole-source items, or purchases from vendors suspected of improper practices.

(3) Audit of other items on a selective basis, using the most practical sampling methods available in the circumstances.

(4) Stratify or group the purchases to be audited in some meaningful way, such as by dollar amounts, buyers, contracts, types of material, products, departments, vendors, or a combination of these and other factors.

6-304 Evaluation of Policies, Procedures, and Controls

Whether performed to support a DFARS 242.72 evaluation or in conjunction with other functional audits, the auditor must have a basic understanding of the contractor's policies, procedures, and controls. In many audits, the auditor expresses an opinion on the allowability, allocability, and reasonableness of material costs. Understanding the system and determining the level of reliance that can be placed on existing controls will direct-

ly influence the extent of testing and verification necessary to express an opinion. (See CAM 5-700 for guidance on understanding, documenting, and assessing internal controls relating to contractor MMASs). The frequency of a complete material cycle review, or the selection of specific functions within the cycle for review, will depend on the significance of material costs charged to government contracts; the results of the current review of this area including the number of deficiencies noted and the significance of the deficiencies; and the frequency with which key contractor personnel, charged with the responsibility for carrying out the functions, are reassigned or are separated from the company.

6-305 Accounting for Material Cost

a. The accounting department is the focal point for material cost control, because it correlates the cost data applicable to requisitioning, purchasing, receiving, storing, issuing, and finally paying for the material. The audit of the accounting system for material costs includes (1) an evaluation of the internal accounting controls, including the type of accounting system in use and the methods used to control the level of material costs; and (2) a determination of the propriety, consistency, and logic of the pricing procedures; the composition and allocation of material charges; and the manner in which payments are made.

b. The distribution of material charges to contracts, accounts, projects, or work orders offers various opportunities for misrepresentation of material costs. Fraud cases have included the following examples: altered vendor invoices, duplicate claims for material on public vouchers and progress payments, fraudulent billings from dummy companies, kick-back arrangements, claims for materials not received, claims for materials not required by the contract, and claiming material cost applicable to other contracts because of funding limitations. Suspicions of these or similar practices should be reviewed for possible reporting under 4-700.

6-305.1 Audit Objectives

The basic audit objectives for the accounting function are to determine the adequacy of the contractor's policies, procedures, and internal controls and the extent to which this function influences the allowability, allocability, and reasonableness of material and purchased service related costs. These objectives include satisfying applicable portions of mandatory annual audit requirements related to purchases adjusting entries/exception reports (No. 11) and purchases existence/consumption (No. 13).

6-305.2 Internal Controls

a. The adequacy of the contractor's material management and accounting system will influence the scope of audit and the degree of reliance that can be placed on the results. For example, when standard costs are used, consistency in establishing the standards and in applying the variances should be reviewed. The contractor may be experiencing a high loss factor and significant material price fluctuations in processing materials for commercial production, while losses and fluctuations for the government operation are negligible. In this situation, the standard material variance should be adjusted for the high losses and price fluctuations before the variances are applied to the government production. As an alternative, a separate material variance factor could be established for application to government production.

b. Review and evaluate the contractor's procedures and internal controls for pricing direct and indirect materials (see CAM 5-700).

6-305.3 Audit Guidelines

In formulating an audit program for evaluating the accounting for material costs, consider the following guidelines:

a. Mandatory Annual Audit Requirements (MAARs)

(1) A review of adjusting journal entries and exception reports related to material purchases should be made to identify adjustments and/or exceptions that require further audit analysis and/or explanation (MAAR 11). In making this review, determine the reliability of the

contractor's system for processing vendor payments and distribution of costs to contracts or other cost objectives. This review should include the testing and matching of purchase orders, receiving reports, and payments (this may require technical assistance in some cases). Also, a verification should be made of purchase requisitions to contract requirements (such as specifications or bill of materials) to determine whether contract charges for purchases are for materials received and services provided in performance of the government contracts. Of concern here is that the contractor has valid time-phased requirements and is not acquiring material far in advance of need (see 6-308).

(2) Review material purchases to test that the materials were in fact received and, if applicable, used on the contract charged (MAAR 13). This MAAR is classified as partially concurrent. The concurrent portion must be performed for the current year during the first field visit to the contractor facility within the year. This will normally be accomplished during a price proposal review or annual incurred cost audit, or within a specific material audit assignment. Material physical observations should be performed annually except for low-risk contractors which require no other field visits during the year. The decision to not perform the annual material physical observation must be documented including the risk factors considered in the decision (e.g., adequate accounting system and material accounting procedures and no prior material charging problems or identified vulnerabilities). Specifically, ascertain that the material was (a) needed for the contract, (b) purchased in reasonable quantity, (c) purchased at a prudent price, (d) used on the contract, and (e) properly accounted for as to initial charge, transfer in or out, and residual value.

(3) Physical observations and other steps needed to gain evidence of proper usage of material and services purchased can in most cases best be done as part of a review covered in 6-306 or 6-312 below.

b. Pricing and Composition of Material Charges

(1) When materials are purchased and charged directly to the contract, the audit tests should include comparisons between the items included in the bill of material, work orders or similar records, purchase requisitions, purchase orders, receiving and issuing documents, and vendors' invoices.

(2) All significant transactions involving any charging to government contracts on a basis other than cost should be reviewed and evaluated. In some cases, the contractor may obtain materials, supplies, or services required for contract performance by a "sale" or interorganizational transfer between a division, subsidiary, or affiliate under common control. These "sales" or interorganizational transfers should be charged to government contracts at cost unless they meet the criteria in FAR 31.205-26(e) for transfer on a price basis or are otherwise specifically stated in the contract. (For further guidance regarding intracompany transfers see 6-313)

(3) When materials are requisitioned from stores, the auditor's tests should include items charged to work orders or similar cost records. The requisitioning procedure and the manner in which the material withdrawals are ultimately reflected in the general ledger accounts should be evaluated. When the contractor maintains perpetual inventory records, examine and test the contractor's procedures for adding to and relieving the inventory records (see 6-312).

(4) Review and appraise the adequacy and usefulness of the stock record cards or other records used to provide information on the location, nomenclature, and quantities of items in inventory. Also, determine whether any inventory algorithms used are based on valid and current data.

(5) Miscellaneous costs associated with material purchases charged directly or as items of indirect costs, such as transportation and material handling charges, should be reviewed and evaluated. In verifying these costs, determine whether the accounting treatment is reasonable and consistent. Circumstances requiring special attention are:

(a) The contractor may charge transportation on material purchased for gov-

ernment contracts as direct contract cost, and the transportation on material purchased for commercial work to overhead. In this case, the government will absorb excessive costs if the commercial transportation costs are not eliminated from overhead.

(b) Contractors may add material handling charges to the cost of materials by applying a percentage factor to the invoice cost. When the factor is arbitrarily determined without specific identification of the costs in the records or without eliminating such costs from the overhead, question the costs for the appropriate reason, (e.g., for lack of records or for duplication of costs). When handling costs are computed on a recognized and acceptable accounting basis (such as when a separate pool is maintained for expenses of this nature and the allocation is made on an appropriate basis), then the additional charge for material handling may be accepted by the auditor subject to the test of reasonableness. The auditor's review of material handling costs should determine the reasonableness of the costs and whether they represent specifically identifiable items which are not included in any allocable indirect cost pool.

(6) Materials fraud is often perpetrated by charging inflated material prices to the government based on fictitious or dummy company invoices. A common method used to make improper charges to flexibly priced contracts is to change the account number to which a vendor invoice is charged. Accordingly, be alert for accounting miscommunication intended to conceal the true purpose of an expenditure.

c. Payment for Materials

The audit of payments for materials should include a review and evaluation of the internal control procedures and the testing and verification of the invoice processing and payment functions. A review of material payments should also verify that the distribution of costs to cost objectives is consistent with payments. In some automated systems, the distribution of costs may be separate from payment allowing the possibility of billing material to government contracts before the contractor actually makes pay-

ment for the materials. In this connection, review the aging of the payables to determine whether there is a large amount of materials or services not paid for but billed on contracts. Conversely, ensure that the contractor is not paying for material (e.g., to take advantage of discounts) unless it has proper proof of receipt (see 6-311).

d. Material Transfers Between Contracts

(1) Material may be transferred at actual cost or standard cost or according to some other generally accepted inventory costing method as long as it is consistently applied, is equitable, and is based on unbiased logic. As to indirect costs allocable to the prime costs, CAS 410.50(i) provides the proper accounting for allocating G&A costs and for transfers. In general, material transfers should be priced using the G&A (or overhead) rate derived when the material was purchased/manufactured. The auditor should ascertain compliance with these standards.

(2) Normally a transfer of parts will also mean that the related cost is transferred within the same billing period. However, in some limited circumstances it may not be appropriate to transfer parts and associated costs within the same billing period. In these cases, use of a "loan/pay back" technique must be approved by the ACO. The loan/payback technique is the movement of materials from one contract to another contract that has a more pressing production requirement without a transfer of cost because the contractor plans to pay back the materials once additional parts are received. When the technique is used, there must be controls to ensure that:

- (i) parts are paid back expeditiously
 - (ii) procedures and controls are in place to correct any overbilling that might occur
 - (iii) at a minimum the borrowing contract and the date the part was borrowed are identified monthly
 - (iv) the cost of the replacement part is charged to the borrowing contract.
- (3) When a loan/pay back transfer is made, the audit concerns are that:
- (i) borrowed parts are not paid back on a timely basis or never paid back

(ii) progress and/or final payments are received by the contractor for the same part on more than one cost objective resulting in double billings

(iii) there is no audit trail or evidence providing visibility of the lending or borrowing contract, or when the parts were borrowed and/or paid back

(iv) the borrowing contract was not charged for the cost of the replacement parts. Perform appropriate tests to ensure loan/pay backs have been treated properly.

6-306 Physical Inventories and Adjustments

a. Fundamental to the viability of any inventory control system is a requirement that recorded inventory accurately reflects actual, physical inventory. The contractor, therefore, must establish and maintain adequate controls to ensure acceptable levels of record accuracy. Contractors' procedures to verify the quantities and dollar value of physical inventories may include test counts of inventories on hand, comparison of the actual count with the quantity reflected in the inventory control records, appropriate adjustments for differences between book inventory and the physical count, and verification that inventory pricing factors are determined on an acceptable basis.

b. The government has an interest in contractors' effective utilization of inventories. Effective utilization of inventories requires that the investment be kept to a minimum and that management know the quantities, quality, and location of goods on hand.

c. The government is also interested in whether the contractor makes an adequate investigation of inventory adjustments and whether losses are acceptable as reasonable costs on government contracts. Adjustments of losses and overages and deterioration of inventory items may indicate inadequate inventory control and storage procedures. Adjustments of items that are surplus or obsolete may indicate the contractor is purchasing excessive quantities.

d. Some contractors' policies, procedures, and practices result in a lack of

perpetual inventory records once materials have been physically issued to work-in-process. In these cases, the shop control function must maintain adequate records to manage and account for issued inventory. Specific attention should therefore be given to the procedures governing perpetual inventory records (see 6-312).

6-306.1 Audit Objectives

The audit objectives are to determine whether the:

(1) contractor's policies, procedures, and internal controls relating to physical inventories are adequate

(2) differences between the physical count and book inventories are accounted for and adequately explained

(3) total inventory value represents correct quantities appropriately priced

(4) inventory levels indicate a balanced stockage position.

In addition, these objectives include satisfying applicable portions of the mandatory annual audit requirement related to purchases adjusting entries/exception reports (MAAR No.11).

6-306.2 Internal Controls

Adequate internal controls provide some degree of assurance on the dollar value and physical quantities of the inventory. Inadequate internal controls may result in excessive charges to government contracts and the use of erroneous cost data by management (see 5-710).

6-306.3 Audit Guidelines

a. When it is anticipated that the dollar value of the physical inventory adjustments will have a significant effect on government contract prices, arrange to observe the taking of the inventory. This should include an evaluation of the planning and the adjustment phase which follows and a review of the journal entries adjusting the book inventory to physical inventory.

b. In developing the audit program, consider the following steps:

(1) Review, evaluate, and test the contractor's procedures for establishing an inventory cut-off for inventory in transit during the inventory-taking period to

preclude improper treatment of items in transit.

(2) Review the manner in which the physical inventory is reconciled with the book inventory. This review should include an evaluation of the inventory adjustments and the contractor's investigation of the reasons for the adjustments. It also should determine whether necessary adjustments are acceptable as reasonable costs on government contracts and whether they result from inadequate internal controls. Adjustments of losses and overages, and deterioration of inventory, may indicate inadequate control and storage procedures. Adjustments of items that are surplus or obsolete may indicate (a) the purchase of excessive quantities, (b) inadequate control of change orders, (c) weak production scheduling and control, or (d) another significant cost management problem. Such matters may need to be checked further in another review (see DCAA Forms 7640-22a and b, Audit Leads).

(3) Test and evaluate the contractor's records supporting the physical inventory and test areas such as the pricing and the arithmetical accuracy of the computations and footings. A large number of material expeditors, substantial excess inventory, and frequent shortages of material to satisfy production needs may indicate that the formal system is not providing accurate information regarding what materials are needed, when materials are needed, and/or what materials are already available in inventory.

(4) Determine whether the contractor segregated any inventory adjustments resulting from price fluctuations due to market conditions.

(5) Determine whether inventory adjustments relate to the performance period of the contracts under audit.

(6) Ensure that the contractor has adequate controls over physically commingled inventories to allow proper charging to contracts.

c. Additional guidance on material handling can be found in 6-312 and section 11,040 of DCAAP 7641.73, Guidelines for Operations Audits.

d. Performance of the above procedures will satisfy the applicable portions of mandatory annual audit requirement

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No. 11, which requires review of adjusting entries/exception reports related to materials to identify adjustments and/or exceptions that require further audit analysis.

6-307 Scrap, Spoilage, Excess, and Obsolescence

This paragraph presents audit guidance applicable to scrap, and to spoiled, excess, and obsolete materials.

6-307.1 Audit Objectives

The audit objectives are to determine whether (1) the scrap, spoiled, excess, and obsolete material generated is reasonable in amount; (2) the physical property is adequately safeguarded; (3) the price received through sale or other disposal is equitable; and (4) the receipts from the sale or other disposal are reasonable and properly credited.

6-307.2 Audit Guidelines-Scrap and Spoilage

There are various methods for accounting for costs of scrap and spoilage. The method which should be used depends in part on the type of plant operation. Costs may be charged as overhead, as a variance to be applied to the material costs, as loading factors to material costs, or direct to a specific contract. When scrap and spoilage costs are associated with material costs, they may be commingled with the regular material costs or may be identified separately. The audit considerations listed below should be included in the audit program for review of this area:

a. When practicable, scrap and spoiled items resulting from the performance of government contracts should be segregated physically from scrap and spoiled items resulting from commercial contracts and should be accounted for separately. The auditor should observe the contractor's stock of scrap and determine the cause for any large quantities of scrapped or spoiled items. Particularly be alert to the possibility that the cause of such scrap may be capital equipment that is faulty or inadequate for its current use.

b. When scrap and spoilage costs have been charged direct to contracts, proceeds from the sale of the material as

scrap should be credited to the appropriate government contract.

c. The contractor may maintain statistical records to accumulate scrap and spoilage cost data when these costs are not separately identified in the accounting records. These statistical records should be reviewed for completeness and reliability.

d. When scrap and spoilage costs are not separately identified, or are not separately accounted for in the records, the total proceeds from sales should be allocated in an equitable manner.

e. When the auditor's review indicates that the contractor has incurred excessive scrap or spoilage costs or there is an apparent misuse of government material, request the services of a qualified government representative to assist in determining the reasonableness of cost. Also be alert to instances of scrap caused by failure of the production unit to promptly receive and implement engineering changes in the product or failure to suspend production of deficient items pending resolution of the problems involved.

6-307.3 Audit Guidelines-Excess and Obsolete Materials

a. Excess or obsolete items may be from purchased material or parts, or manufactured parts. Evaluate the contractor's policy for recording and recovering obsolescence costs and review the causes which generated the obsolete items. In addition, be alert to those situations in which the contractor (1) is reimbursed for the cost of obsolete items but subsequently sells them to a subsidiary or affiliate at significantly reduced prices, (2) uses the items as a no-cost component on the contractor's commercial work or in performing a firm fixed-price or incentive contract for the government, or (3) scraps items and then buys similar items from surplus or salvage dealers. Practices of this nature should be reported to the contracting officer and should also be considered for possible reporting under 4-700 or 4-800.

b. The contractor's procedures and practices for using or disposing of excess or obsolete items should be evaluated, including:

(1) Screening procedures adopted in order to determine whether parts produced under, but no longer needed for, a particular contract can be used on other contracts. These items should be transferred for use without charge to the government.

(2) Procedures for obtaining the highest possible prices on items sold or scrapped.

(3) Procedures for ensuring that the government receives proper credit for proceeds of items sold or scrapped. Related adjusting entries should be reviewed for appropriateness (as required by mandatory annual audit requirement No. 11—see 6-305.3).

6-308 Determination of Requirements

The decision to purchase a standard item, the quantity required, and the timing of the delivery usually are the responsibility of such departments or functions as planning and production control, engineering, storeroom, and office services. Deciding to buy nonstandard items is frequently delegated to a make or buy committee or a similar group. See 5-702 on the use of MRP systems to determine requirements.

6-308.1 Audit Objectives

a. The audit objectives of this area are to determine the extent of coordination between the purchasing function and the departments responsible for determining requirements. Effective coordination may have a significant impact on purchasing economies and production efficiencies and in turn may affect the ultimate cost to the government. The quality, quantity, and delivery date of materials to be purchased may be based on information generated by (1) stock level requirements established for standard items, (2) bills of material coordinated with production schedules, and (3) individual purchase requests from departments authorized to requisition material.

b. The need for special tooling or special test equipment is generally established at the proposal or negotiation stage (9-603.2). These special items, which are not part of the deliverable end product under the contract, must comply with the

definitions in FAR 45.101, and the FAR requirements for approval, control, accountability, use, and disposition (see 7-1906 and 14-400).

6-308.2 Internal Controls

The material purchases by the contractor's buyers should be based on requests received from departments responsible for material requirements. The audit effort, therefore, should depend on the effectiveness of the contractor's internal control system affecting the requisitioning and buying activities. A review and evaluation of the internal control system should be made to determine whether all purchase actions are in response to need, supported by properly initiated and approved requisitions, and accomplished in a timely and effective manner. See CAM 5-600 for guidance on performing contractor purchasing system reviews.

6-308.3 Audit Guidelines

a. Of particular concern here are (i) claimed costs not properly traceable to source documents, (ii) excess material costs being charged to government contracts, (iii) no audit trail supporting "no cost" transfers of material, (iv) loans of materials to other contracts outstanding for an excessive time period, and (v) inaccurate material records (also see 6-306). Accordingly, the audit of the interrelation and coordination of the purchasing and requisitioning functions should include, but not be limited to, a review and evaluation of:

(1) Buying practices to determine whether a pattern of rush, emergency, or premature buying exists which may have resulted in (a) increased purchase prices, (b) excessive use of uneconomical transportation, (c) delays in production and engineering operations, (d) excessive obsolescence as a result of subsequent changes, or (e) premature billing of material costs.

(2) The followup procedures used by the purchasing department to ensure timely deliveries.

(3) Modifications to purchase orders to determine if changes in specifications and quantities have resulted in obsolescence or increased costs and to determine whether changes were due to poor plan-

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ning and lack of coordination, the untimely processing of purchase orders, or other causes that could have been avoided by better management practices.

(4) Significant increases in material costs charged to government contracts to determine if increases were due to year-end inventory write-downs and whether write-downs resulted from inefficient requisitioning procedures and purchasing operations.

(5) Coordination procedures when there are indications of repeated requisitioning of small quantities of the same item with substantial increase in costs to government contracts.

(6) Controls that prevent requisitioning materials in excessive quantities or premature charging to government contracts, resulting in unnecessary material costs and in increased storage and material handling charges to the government.

(7) Trends in transfers from one type of contract to another or significant increases in cost transfers from one month to another that might indicate system control problems.

b. Additional guidance on material requirements can be found in section 11,030 of DCAAP 7641.73, Guidelines for Operations Audits.

6-309 Make or Buy Decisions

The contractor's make or buy decisions determine which components, assemblies, subassemblies, or parts are to be manufactured and which are to be purchased. These determinations affect contract prices, contract performance, and adherence to government procurement policies.

6-309.1 Audit Objectives

The objectives when reviewing this area are to determine whether make or buy decisions (1) are reasonable in concept, (2) are applied effectively, (3) are in compliance with FAR 15.7, and (4) generally result in the lowest cost to the government.

6-309.2 Internal Controls

CAM 5-600 contains detailed guidance for reviewing contractor purchasing systems including make-vs-buy decisions.

The guidance in 14-700 on economy and efficiency audits of capital investments is equally applicable in the review of make or buy determinations.

6-309.3 Audit Guidelines

a. FAR Subpart 15.7 generally requires contractors to submit make or buy programs for all negotiated acquisitions with an estimated value of \$5 million or more (see exception at FAR 15.703). It also allows, for monitoring purposes, the incorporation of the program in negotiated cost-reimbursable contracts, some cost sharing contracts and major systems contracts and subcontracts for monitoring purposes. The contract clause at 52.215-21 requires notification of any changes in the program as incorporated in the contract. Alternates 1 and 2 requires adjustment of incentive fees if during performance the contractor reverses a make or buy categorization which initially was economically detrimental to the Government. Determine the effect of and compliance with any agreements resulting from these requirements.

b. The contractor has the basic responsibility for make-or-buy decisions. Therefore, its recommendations should be accepted unless they are inconsistent with Government interests or policy (FAR 15.706(c)). Evaluate the contractor's decisions in the make or buy area which may have been motivated by considerations other than economies or efficiencies for the government operation. For example, the contractor may desire to gain experience in a particular manufacturing or fabricating process. Another consideration which may influence a contractor's make or buy decisions involves the extent of available idle facilities. The contractor's decision to manufacture in lieu of purchase may be in the best interests of the company, but not in the best interests of the government. When a contractor decides to manufacture a part or component not normally within its experience or production capabilities or which had been purchased in the past, determine whether the decision results in additional costs to the government.

6-310 Purchasing and Subcontracting

a. The purchasing and subcontracting function includes make or buy decisions (6-308) the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administration of orders, and expediting delivery of materials.

b. When DCAA internal control reviews or FAR required contractor purchasing system reviews (CPSRs) are regularly performed at a contractor location, the auditor will make maximum use of the work performed and the conclusions reached during these reviews in establishing the extent of any separate coverage and audit tests to be undertaken in this area (see 5-600). In addition, the auditor and the cognizant government procurement office have related responsibilities regarding purchasing and subcontracting. It is imperative that the auditor coordinate planned reviews with the procurement office to avoid duplication of effort (see 5-1302 and FAR Part 44).

6-310.1 Audit Objectives

The audit objectives of this area are to determine whether the contractor: made reasonable make or buy decisions (see 3-309); ensures the purchase of only properly determined requirements (see 3-307); obtained maximum competition; made a proper analysis of quoted prices; made a reasonable attempt to negotiate with the vendors; had a reasonable basis for vendor selection; has reasonable internal controls over placement and administration of orders (5-600); and is expediting delivery of materials where appropriate. In addition, these objectives include satisfying applicable portions of mandatory annual audit requirements related to auditable subcontracts/assist audits (MAAR No. 12).

6-310.2 Internal Controls

An adequate internal control system for purchasing and subcontracting activities requires, as a minimum, effective management policies, implemented by written procedures which will allow the contractor to control the level of costs. Effective internal controls require that the most recent policies and procedures

related to the purchasing and subcontracting function be made available to all personnel concerned. All purchasing department personnel should understand their assigned responsibilities, authority, and limitations. Section 5-600 contains detailed guidance on reviewing and reporting on contractor purchasing system internal controls.

6-310.3 Audit Guidelines-Basic Procedures

In formulating an audit program for evaluating purchasing and subcontracting, consider the reliance to be placed on the internal control structure. The specific scope of audit for testing and verifying the purchasing system is a matter of auditor judgement. When material costs are significant, the auditor should consider the following when designing the substantive testing:

a. Testing Methods. The auditor should consider testing: (i) all large purchases; (ii) all sensitive purchases, such as scarce materials, sole-source items, or purchases from vendors suspected of improper selection; and (iii) all other items on a selective basis, using the most practical sampling methods available in the circumstances. For example, stratify or group the purchases to be audited in some meaningful way, such as dollar amounts, buyers, contracts, types of material, products, departments, vendors, or a combination of these factors.

b. Sufficient Competition. Evaluate whether there were bid solicitations from a sufficient number of prospective sources to promote effective competition commensurate with the nature and dollar value of the purchase action.

c. Basis for Selection. Factors to be considered when evaluating purchases involving noncompetitive items are whether (1) the vendor was designated by the contracting officer who awarded the prime contract and (2) the purchase, if made from a sole source supplier, was approved by a responsible company official.

d. Negotiation. The auditor should (1) identify those awards made to other than the low bidder and determine whether the purchase files reflect the justification for the rejection of the low bidder and the

basis for the selection, (2) ascertain if the contract files contain sufficient evidence of negotiation when it is necessary to establish a reasonable price because the item is nonstandard or an insufficient number of bids have been received, (3) determine the extent of the review given the supporting data submitted by the prospective vendor, (4) ascertain if the type of subcontract issued meets the requirements of FAR Part 16 and includes all clauses required by the prime contract, (5) determine if awards have been made to other than the low bidder on the basis of delivery, the purchase order should provide for a downward price adjustment if delivery schedules are not met, and (6) determine if there is sufficient justification for awarding intracompany purchases or work orders.

e. Unallowable Procurement. Determine whether the contractor issued any cost-plus-a-percentage-of-cost subcontracts (FAR 44.203(b)(2)). Under this type of procurement, the subcontractor would receive payment for, and the prime contractor would pass on to the government as cost of its contract, the costs incurred in performing the contract, plus a specified percentage of such costs as a profit or fee. Thus, the fee would increase in direct proportion to any increase in cost.

6-310.4 Audit Guidelines-Subcontracts

a. Analysis of Case Files. Review the upper-tier contractor's subcontract files to ensure that all required subcontract cost or pricing data was obtained and all analysis work made by the upper-tier contractor was properly provided to the government in any price negotiations with the government.

b. Subcontract Changes. In evaluating subcontract changes which affect cost or price, consider the (1) reasons for the change, (2) reasonableness of the adjustments to the subcontract price or cost, (3) complexity or risk involved, and (4) reasonableness of profit or fee adjustment compared to the estimated cost of the change. When the cost of the subcontract before the change has exceeded or is expected to exceed original estimates, be alert to changes which have been overpriced to avoid an overall loss or to

provide total profit or fee in accordance with original contract estimates.

c. Administration of Subcontracts. The auditor should review and evaluate whether the upper-tier contractor expedites delivery where appropriate, and meets the FAR requirements for change orders, modification notices, and overall costs (refer to purchasing system section 5-600).

d. Repricing. The auditor should determine whether the (1) revised contract prices are negotiated or arrived at as provided by contractual requirements; (2) cost or pricing data which was used as the basis for repricing is accurate, complete, and current; and (3) results of the repricing action are in the best interests of the government.

e. Purchases from Debarred Companies. Debarred or suspended contractors are excluded from receiving contracts; and agencies shall not solicit offers from, award contracts to, or consent to subcontract with these contractors, unless the acquiring agency's head or a designee determines that there is a compelling reason for such action, as explained in FAR 9.405-2, 9.406-1(c) and 9.407-1(d). An important criterion in determining the propriety and allowability of payments for material purchases or subcontracts is the "consent" requirement of specific contracts. FAR 52.244-1 through 52.244-5 are the pertinent solicitation provisions and contract clauses which, if included in a contract, delineate the "consent" requirements by types and categories of contracts. If by the terms of the contract, prior consent is required of the ACO in subcontracting/purchasing, the ACO is prohibited from consenting to award to a debarred contractor. "Consent" here means to consent to contract with a particular entity or person; not consent to make a purchase. If prior consent is not required or if it is required for approval to make purchases only, a prime contractor is free to solicit from any sources available, including debarred, suspended, or ineligible contractors.

When the prime contractor has failed to comply with the "consent" requirements of a contract, consult with the contractor to determine if any additional

data exists to preclude the suspension of costs. If the contractor cannot provide an adequate explanation or documentary support for audit approval of payments on public vouchers, the costs should be suspended and brought to the attention of the ACO.

6-310.5 Audit Guidelines-Breakout of Material Purchases

a. A review of this area should determine whether material or component parts purchased by the contractor for incorporation in the contract end item include common items of high-cost major components or subassemblies. When common items are included, analyze the material cost to determine if a "break-out" (government direct purchase) of common items would reduce costs charged to government contracts. When warranted, consult with the contracting officer and point out the possible desirability of acquisition of items directly and furnishing them to the prime contractor as government-furnished material.

b. In addition to breakout of common items, the contractor may purchase other items which would be more economical for the government to purchase directly. Spare parts procurement is an area which deserves special attention because, in some instances, the prime contractor may perform only the procurement function; and it may be more economical and practical for the government to procure parts directly from the supplier. The extent to which drop shipments are made by manufacturers to the government using activities will provide an indication of the extent of prime contractor efforts relative to the spare parts. Special attention should also be given to pricing formulas or accounting methods that allocate/assign unreasonable or unwarranted costs to spares or for indications of excessive profits on spares contracts.

6-311 Receiving and Inspection

The receiving activity is responsible for the receipt and inspection of incoming materials and the movement of these materials to the areas where the storage and usage functions are carried out.

Common responsibilities include: (1) unloading, unpacking, identifying, sorting and verifying that the quantity and quality of materials received agree with purchase order requirements; (2) noting shortages, damage, and defects; (3) reporting receipts and discrepancies; (4) moving materials to storage or other appropriate activities; and (5) providing appropriate transaction inputs to the inventory requirements and accounting systems.

6-311.1 Audit Objectives

The audit objectives in reviewing the contractor's receiving and inspection function are to determine whether this area has effective policies, procedures, and internal controls and whether it helps ensure that allowable, allocable, and reasonable costs are charged to government contracts.

6-311.2 Internal Controls

Receiving and inspection controls are typically reviewed as part of an MMAS review. If an MMAS review has been performed, the auditor should refer to the MMAS portion of the ICAPS to obtain an understanding of the control risk related to this area. If an MMAS review has not been performed, the auditor may want to perform audit steps to assess control risk relating to the receiving and inspection function (see CAM 5-710.1). In any case, the auditor's assessment of control risk should be noted in the working papers and reflected in the scope of the review.

6-311.3 Audit Guidelines

In developing an audit program for reviewing and evaluating the receiving and inspection function, consider the following guidelines.

a. The auditor should physically observe the receiving and inspection functions and examine selected transactions to test whether key internal accounting control requirements are being carried out correctly. Also be alert to any inefficiencies caused by poor work layout or poorly planned and executed movement of materials. Attention should be given to signs of bottlenecks, idle personnel, excess or slow-moving materials, poor ma-

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terial handling practices, and inadequate protection of material from theft and the elements.

b. The contractor may establish sampling techniques to be applied to the quantitative and qualitative receipt and inspection of material. The auditor must ascertain whether the sampling techniques are formalized and will permit a review and evaluation of the propriety of both the techniques applied and the results. Also ascertain whether there is adequate supervision during the counting and inspection phases.

c. Additional guidance related to certain aspects of the receiving and inspection function can be found in section 11,020 of DCAAP 7641.73, Guidelines for Operations Audits.

6-312 Storing and Issuing

The storing and issuing function is responsible for (1) the protection and preservation of material in storage, including appropriate safeguards for items of a sensitive nature and items subject to deterioration by the elements; (2) accessibility of fast-moving items; (3) the examination of material requisitions for the appropriate stock number, nomenclature, and authorized usage; (4) a knowledge of items, to permit substitution if appropriate when a requisitioned item is not available; (5) the timely issuance of material when presented with an authorized requisition; (6) initiating purchase requisitions when stock levels reach the reorder point or when authorized requisitions cannot be filled, duly noting due-ins and due-outs; (7) reviewing stock for slow-moving items and items in long supply and initiating appropriate action for consumption or disposal; and (8) providing appropriate transaction inputs to the inventory requirements and accounting systems.

6-312.1 Audit Objectives

The major audit objectives in reviewing storage and issuing are to determine:

a. If accounting documentation is properly prepared/controlled and the material is properly stored and protected from pilferage, the weather, and other hazards. Material should be issued from

stores as required, with proper documentation, and support the production schedule.

b. Storerooms are arranged to promote economy and efficiency in storing, locating, and issuing material.

c. If the movement of material from receiving and inspection to storage and then to production is reported for proper entries in the accounting records. When material flows directly from receiving and inspection to production (bypassing storage), equivalent accounting control is likewise maintained.

6-312.2 Internal Controls

Storage and issuance controls are typically reviewed as part of an MMAS review. If an MMAS review has been performed, the auditor should refer to the MMAS portion of the ICAPS to obtain an understanding of the control risk related to this area. If an MMAS review has not been performed, the auditor may want to perform audit steps to assess control risk relating to the storage and issuance function (see CAM 5-710.2). In any case, the auditor's assessment of control risk should be noted in the working papers and reflected in the scope of the review.

6-312.3 Audit Guidelines

The auditor should consider the following in developing an audit program.

a. Determine by observing, evaluating, and testing the practices and documentation in the warehouses, storerooms, and factory whether the amount of merchandise withdrawn from stores is adequate but not in excess of current needs.

b. Determine the accuracy of the records of materials in transit from the warehouse or storeroom area to the production area.

c. Make physical observations and tests of documentation in production areas to determine whether material is being used in a timely manner and for the purposes for which it was issued.

d. Test the application of procedures for (1) returning material to the storeroom, (2) replacing material in stock, and (3) correcting the inventory and cost records to reflect the return. Change orders and cutback in production sched-

ules usually require the return of material issued to production.

e. Verify the delivery of requisitioned items and evaluate the procedures for handling replacement orders for material lost in delivery.

f. Test effectiveness of inventory controls and management by examining a representative number of contractor-acquired government-owned (excluding government furnished material) and contractor-owned items in order to review the (1) basis for establishing stock levels and reorder points, (2) causes for any items in short supply, and (3) actions taken in response to data shown in inventory and stock status reports prepared by the contractor.

g. Test the flow of accounting data to the accounting department.

h. Review the additional guidance concerning the storing and issuing functions in section 11,020 of DCAAP 7641.73, Guidelines for Operations Audits.

6-313 Intracompany Transfers

6-313.1 Introduction

a. Careful consideration should be given to items or services transferred at amounts other than cost. Of particular importance is whether the price charged for the item has been established by a competitive market place. If the item is (1) proprietary, (2) sole source, or (3) produced solely or substantially for government end use, it may be concluded that it does not meet the requirement for acceptance at price. Under these conditions, amounts in excess of actual or estimated cost should be questioned.

b. For a contractor to obtain reimbursement on a basis other than cost, for items or services sold or transferred between divisions, subsidiaries, or organizations under common control, certain requirements of FAR 31.205-26(e) must be met. The initial requirement is that the transferring organization have an established practice of pricing interorganizational transfers of materials, supplies and services at other than cost for commercial work of any division, subsidiary, or affiliate of the contractor under a common control.

c. The existence of an established practice should be readily determinable from evidence such as catalogs, sales information, and delivery records. Once the auditor is satisfied that the transferring organization has such a practice, a determination should be made as to whether reimbursement for the item under consideration is being requested (1) on the basis of an "established catalog or market price of commercial items sold in substantial quantities to the general public," or (2) on the basis of "adequate price competition." This determination should facilitate further review in accordance with the following guidelines.

6-313.2 Established Catalog or Market Price

a. FAR 31.205-26(e)(1) refers to criteria contained in FAR 15.804-3(c) for use in determining whether an item falls within the scope of this alternative. Generally, to meet these criteria the price must be, or be based on, an established catalog or market price of commercial items sold in substantial quantities to the general public. A listing in a catalog does not, of itself, make the price allowable. The contractor should be required to demonstrate the basis of the price and subsequent price increases by presenting sales information such as quantities sold, dates of sale, prices for the quantities sold, purchaser, relationship of purchaser to the organization, extent of sales for commercial and government end-use, extent of sales to any division, subsidiary, affiliate, or other organization under common control, quantity discount schedules, and comparisons between the item being sold and similar items sold previously and used as the basis for the catalog price.

b. Sales for government end-use or sales to affiliates under common control are not considered sales to the general public and do not provide a sufficient basis for establishing a competitive, commercial catalog price. The determination as to whether all the criteria set forth in FAR 15.804-3(c) have been met is to be made on an item basis as opposed to a product line approach and requires the use of judgment in several areas. The overall objective is to determine whether

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the price of the item resulted from a competitive market.

c. The use of judgment is required, for example, in determining if an item has been "sold in substantial quantities." No specific guidance can be provided on what percentage of the total units sold must be sold on the commercial market or how many items must be sold in order to qualify as "substantial." It is possible that a small percentage of commercial units may represent a relatively large quantity sold to several different customers on a competitive basis. If so, the auditor may conclude under FAR 15.804-3(c)(4) that the quantity is "sufficient to constitute a real commercial market for the item." However, as a general rule, if 35 percent of the items, assuming a large quantity is involved, are sold to commercial customers the item would meet this criterion.

d. Another area requiring the use of judgment in applying FAR 31.205-26(e)(1) involves the words "or is based on." FAR 15.804-3(c)(6) states, "A price is 'based on' a catalog or market price only if the item being purchased is sufficiently similar to the catalog or market priced commercial item to ensure that any difference in prices can be identified without resort to cost analysis." In other words, the basic item must meet the FAR 31.205-26(e) requirements and the modified item must be sufficiently similar to permit a simple explanation of the price difference. Technical assistance should be obtained in those cases where significant amounts are involved.

e. Determine whether the contractor's catalog is regularly maintained and made available to all potential customers. In some industries, the custom of the trade is to offer items for sale to the general public at catalog prices less announced discounts. Such discounts are stated in percentages of catalog prices, and the percentages may vary according to type of customer, volume, or other parameters. Where this practice is followed, ensure that the catalog price used for intracompany transfers is reduced by the discount percentage applicable to similar sales to the general public.

6-313.3 Adequate Price Competition

a. FAR 31.205-26(e)(2) refers to criteria contained in FAR 15.804-3(b) for use in determining if adequate price competition exists.

b. Price competition will be presumed adequate if at least two responsible offerors that can meet the government's requirements independently contend for a contract to be awarded at the lowest evaluated price, by submitting price offers responsive to the request for bid. There are three exceptions to this presumption of adequate price competition, namely where (1) one or more known qualified offerors are denied an opportunity to compete; (2) the low bidder has such a determinative advantage over other competitors so as to be practically immune to competition; or (3) the lowest price is determined to be unreasonable. The auditor should determine whether in addition to the quotation received from its affiliated organizations to whom the award was made, quotations were also obtained from at least one or more outside sources which normally produce the item or its equivalent in significant quantities.

c. Evaluate whether the contractor made a valid attempt to solicit potentially qualified sources on a broad basis and to negotiate the best competitive price for the item. Reasons should be obtained for not soliciting a reasonable number of qualified suppliers. Where the award is made to other than the lowest bidder, justification should be furnished for the action taken. The contractor should demonstrate that all potential suppliers who submitted bids were bidding under the same set of circumstances (e.g., giving effect to start-up costs, etc.). When the same item or substantially the same item has been purchased recently in like quantities, under circumstances that provided adequate price competition, compare those prices with current prices being claimed by the contractor. Finally, after all factors surrounding the price have been considered, the auditor may still have to make a judgment in each case on whether the contractor's price was truly established through adequate price competition.

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6-313.4 Other Considerations

a. In all cases where interorganizational transfers or sales are made on a price basis, review price and discount schedules, sales invoices and other relevant sources to ascertain that the provision of FAR 31.205-26(e)(3) relating to the use of prices "not in excess of current sales prices to his most favored customer" are observed. In addition, verify that the price has not been determined to be unreasonable by the contracting officer.

b. Occasionally, a contractor may decline to submit documentation supporting catalog or commercial prices. In such a case, the auditor should be guided by and take actions prescribed in 1-504.3. If the prices used for intracompany transfers cannot be adequately substantiated, it may be necessary to suspend or question the amount involved to the extent the proposed price exceeds actual or estimated incurred costs.

6-400 Section 4 — Audit of Incurred Labor Costs

6-401 Introduction

This section contains audit guidance applicable to the review and evaluation of incurred labor costs by area. The evaluation of contractor's policies, procedures, and practices and internal controls which influence labor costs are covered in 5-900. The results of the review of the labor system and related internal controls and assessment of control risk provide the basis for determining the extent and frequency of testing to be performed in each labor cost area. The auditor should review the control risk assessment and related internal control audit planning summary (ICAPS) to determine whether the review of the contractor's labor system and related internal controls identified a specific risk area and that the relevant labor costs are material in amount/impact before planning for substantive tests. Discussion is presented in the following areas: (1) scope of audit, (2) review of labor cost charging and allocation, (3) observations of work areas (floor checks), (4) review of payroll preparation and payment, (5) review of personnel policies and procedures, (6) review of recruitment costs and practices, (7) review of overtime, extra-pay shifts, and multi-shift work, (8) review of uncompensated overtime, (9) review of labor standard cost systems and sole proprietors' and partners' salaries, and (10) evaluation of quantitative and qualitative utilization of labor.

6-402 Audit Objective

a. Accomplishment of the audit objectives will require consideration of each area of the labor system areas listed in 6-401 above. The review cycle and the level of testing will be based on the control risk assessment and the vulnerability and materiality of the labor area involved. Substantive testing may be greatly reduced when the contractor effectively maintains an adequate and compliant system of internal controls, including monitoring and testing of the system.

Substantive testing should be focused in the high risk areas.

b. The discovery of unlawful or fraudulent activities is not the primary audit objective, however, the auditor should be alert to any condition which suggests that such a situation may exist.

c. Labor cost charging and allocation reviews and observations of work area reviews may appear similar but vary in the overall objective and the techniques and procedures used. Review selection is influenced by the perceived risk associated with the recording and accumulation of labor costs. If the resulting audit objectives are to evaluate the contractor's compliance with its labor policies, procedures, and internal controls; compliance with and reliability of the contractor's labor cost accounting system; the accuracy of contractor employee (salaried and/or hourly) labor hour charges to contracts, indirect accounts, or other cost objectives; the procedures in 6-404 are appropriate. If the objectives are to verify the existence of employees and to evaluate compliance with timekeeping internal control procedures, the procedures in 6-405 are appropriate. The auditor should also be concerned with the contractor's compliance to its policies and procedures relating to payroll and personnel, recruitment, overtime, and labor standards.

6-403 Scope of Audit

The extent of audit effort in testing and verifying labor costs will be influenced by (1) the adequacy and reliability of the contractor's system and related internal controls, (2) the nature and significance of labor and related expenses, (3) prior audit experience with the contractor, (4) the reliability and acceptability of the contractor's labor policies and procedures, (5) the audit objectives, (6) the contractor's mix of contracts and nature of contract provisions, and (7) the nature of the contractor's organization and operations.

6-404 Review of Labor Cost Charging and Allocation**6-404.1 Audit Objectives**

a. The primary objective of a labor cost charging and allocation review is to evaluate the accuracy of contractor employee (salaried and hourly) labor hour charges to contracts, indirect accounts, or other cost objectives. The auditor should determine if the recorded labor hour charges are a fair representation of the actual work performed. Hours recorded on an employee's timecard or electronic record must be adequately supported/ documented if they are to be accepted as the basis for reimbursable labor costs on government contracts.

b. An underlining principle of an effective labor charging and allocation review is that it must be performed on a current basis. Experience has shown that long lapses of time between when labor effort is expended and when it is reviewed tend to diminish the effectiveness and productivity of the audit. Ideally, labor allocation reviews should be performed on a real time basis, i.e., labor effort is reviewed at the time of occurrence. From a practical standpoint, however, labor should be reviewed as close as possible to the date of occurrence. This approach has many benefits. The employee should be better able to remember recent events, and sufficient, competent evidential matter to support audit conclusions should be more readily available.

c. It would be impractical with limited audit resources to review an entire labor system at one time. Efforts must be concentrated on those areas requiring immediate attention. To do this, it is necessary to perform an analysis on the contractor's current labor system. The analysis should help the auditor identify those problem areas most likely to result in a significant adverse cost impact to the government (risk) and the extent of government exposure to suspected irregular conduct (vulnerability). The analysis consists of preliminary audit effort, a review of the adequacy of and compliance with internal controls (see 5-900), and consideration of other conditions which may

influence the contractor's labor charging practices.

d. The nature and extent of further audit effort should be based on the outcome of the analysis performed in the review of internal controls (see Chapter 5-900). In most circumstances, effective and productive audits require some physical verification (floor checks/interviews) to arrive at supportable conclusions. In addition, performing floor checks/interviews will satisfy the mandatory annual audit requirement relating to labor floor checks/interviews (MAAR 6). Floor checks are designed to evaluate employee labor charging at a particular point in time and are most often appropriate when the analysis has not identified any high risk areas (see 6-405). Interviews are designed to evaluate employee labor charging over a recent period of time and are most often appropriate in reviewing high risk areas. The two approaches are not necessarily mutually exclusive. A floor check may help identify a potentially high risk area requiring further analysis.

6-404.2 Analysis of Labor Charging and Allocation System

The objective of the analysis of the contractor's labor charging and allocation system is to identify specific areas or situations where there is high risk of labor mischarging. This will usually result in the identification of specific cost or profit centers, departments, contracts or cost objectives, or employees or groups of employees where the potential for mischarging is high.

6-404.3 Preliminary Audit Effort

Because the effectiveness of the audit depends on the auditor's knowledge of the contractor's labor charging and allocation system, the auditor should become familiar with available background information on the contractor's organization, budgetary controls, direct/indirect labor charging policies and procedures, and results of the labor internal controls review (see 5-900). Obtain pertinent information from up-to-date permanent files, coordination with procurement officials, and discussions with the contractor.

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a. Contractor organization charts and listings of current government contracts are very useful sources of information and should be examined and referenced often during the audit. In addition, the auditor should update the labor portion of the permanent file to help satisfy the mandatory annual audit requirement relating to permanent files (MAAR 3).

b. Coordinate the planned audit with the ACO and other contracting officer representatives to:

(1) Ensure that adequate, but not duplicate, coverage of time and material contracts is provided by the auditor and the contracting officer's technical representative (COTR).

(2) Solicit any input that may affect the audit.

(3) Establish procedures for requesting needed technical assistance. (see Appendix D)

(4) Determine if the audit is to be conducted as a joint CAO/DCAA review as provided in DFARS 242.70 (see 15-700).

(5) Establish target dates for status meetings to keep the ACO informed of the audit progress. Bring any difficulties to the ACO's attention for prompt resolution.

(6) Invite the ACO to attend the entrance conference and to suggest conference agenda items.

c. The auditor should hold an entrance conference in accordance with 4-302 to exchange preliminary information about the audit and to enable the contractor to provide a briefing about its direct/indirect labor charging and allocation policies. During the entrance conference the auditor should:

(1) Discuss the general area(s) to be covered and the general period of audit performance.

(2) Advise the contractor that the audit will include a series of unannounced employee floor checks/interviews. The contractor should designate a representative to accompany the audit team during the floor checks/interviews. A primary and alternate representative should be designated for each of the contractor's locations.

(3) Set the ground rules for the interviews and floor checks; e.g., the inter-

views will be unannounced, the team will be comprised of two auditors and a contractor representative, and the representative will not be allowed to interpret the employee's responses nor be allowed to "coach" the employees in their responses.

(4) Request a contractor representative to act as coordinator for discussing audit progress and findings.

6-404.4 Review of the Adequacy of Internal Controls

a. Consideration of the contractor's internal control structure is an important part of the labor audit. An adequate internal control structure is essential if the labor system is to be relied upon for cost reimbursement and as a basis for future estimates. The evaluation of the internal control structure is covered in Chapter 5-900 and must encompass both EDP and manual processes that are used in the accumulation and recording of labor costs. Guidance for the evaluation of EDP system controls is included in Appendix C. The result of the internal controls review will enable the auditor to determine the effectiveness of labor functions and the reliability of labor records; and, when combined with appropriate tests of amounts included in cost representations, will provide a basis on which the auditor can render an opinion as to whether the contractor's labor cost representations are acceptable.

b. Start and Stop Time Recording

Recording of start and stop times is necessary only when the lack of such a control results in a risk of a material labor cost misallocation. Determining the need to record start/stop time is made on a case-by-case basis. The factors that should be considered in assessing the appropriateness of recording start/stop times include (1) nature and variety of tasks worked on each day, (2) significance of employees working on multiple tasks compared to total work force, and (3) mix of contracts. After considering these factors, the DCAA auditor must exercise professional judgment as to whether there is sufficient risk to warrant recommending recording start/stop time. Inherent in determining risk is the concept that the benefit of the control — in this case

recording start/stop time—must exceed the cost of implementation.

c. Carefully consider the possible consequences when internal control inadequacies are significant. Document corrective action taken by the contractor and consider when planning the extent of testing required.

6-404.5 Review of Compliance with Internal Controls

Inadequate internal controls or non-compliance with those controls greatly increase the risk that labor mischarging could be occurring. The scope of the audit should be adjusted in accordance with the risk determined in the review of the labor system of internal controls (See Chapter 5-900).

6-404.6 Review of Conditions Influencing Contractor Labor Charging Practices

a. Proper analysis requires a working knowledge of not only the contractor's operations, policies, and procedures, but also many conditions that may influence management decisions. Normally no one factor should become the sole determinant of whether an audit should be continued, expanded, or terminated. High risk and vulnerability are usually the effect of the relationships among several conditions.

b. Several conditions and appropriate review procedures are presented in this section. The review of these conditions may identify areas (e.g., cost/profit centers, departments, groups of employees, employee labor classifications, or contracts or cost objectives) where the potential for labor mischarging is high. When high risk exists, the auditor must also be alert to the possibility of fraud, and should conduct transaction tests which include a determination that records examined are not falsified. Give special consideration to unusual transactions. Journal entries and other special adjustments may provide leads for discovering improper transactions. Many fraud cases involve deliberately falsified labor distribution, payroll, and other records. Examples include fraudulent charges to cost-type contracts of costs applicable to firm-fixed-price work and fraudulent charges to direct and indirect activities of unre-

lated labor costs when projects, budgets, contract ceilings, or advance agreement (e.g., IR&D/B&P) limitations are about to be exceeded. Although no list can be all-inclusive, the following factors are examples of conditions which may influence labor charging practices. The auditor should identify the specific risk area(s) associated with such conditions by designating them as high, medium, or low risk.

(1) Mix of Contracts

Determine the government contract mix (cost vs. fixed-price/commercial). A contractor whose contracts are all fixed-price or all cost-type would have relatively little incentive to mischarge between contracts. On the other hand, a contractor with a mix of cost-type and fixed-price/commercial work would generally have a much greater motivation to charge effort allocable to fixed-price or commercial work to a cost-reimbursable contract.

(2) Overrun Contracts

When contract costs have exceeded or are projected to exceed contract value, contractors may divert these excess costs to other cost objectives such as indirect labor, overhead accounts, other contracts, etc. Request the contractor to provide a listing of all contracts that are currently in an overrun position or projected to be in an overrun position. The ACO can also often provide information on "trouble contracts."

(3) B&P/IR&D Costs

The auditor should review the incurred costs in these areas to determine if the contractor is treating B&P and IR&D labor as it does normal contract labor. Determine if the contractor is close to or over the allowable cost ceiling (formula or advance agreement). If the contractor is close to or over the ceiling and has cost-type contracts, the risk is high that mischarging may exist, and this area should be further reviewed. Furthermore, reviews in this area may satisfy the mandatory annual audit requirement relating to B&P/IR&D costs (MAAR 17).

(4) Selling and Marketing Costs

Review the relative magnitude of these expenses. B&P and IR&D effort may be misclassified as selling and marketing costs. If selling and marketing costs appear out of line with expectations, the

contractor may have misclassified B&P/IR&D costs in excess of formula or advance agreement ceiling amounts.

(5) Significant Increases in Direct/Indirect Labor Accounts

Trend analyses may disclose instances where charges to direct or indirect labor accounts have increased significantly. Sufficient review should be performed to determine the nature of the increase. The auditor should review changes in procedures and practices for direct/indirect time charging of contractor employees for consistency with generally accepted accounting principles, the applicable contract cost principles, and any applicable Cost Accounting Standards requirements. The auditor should also perform comparative analysis of sensitive labor accounts. If there is no apparent explanation, or conditions exist that would indicate a misclassification of direct labor charges, this should be further reviewed. Reviews in this area may satisfy the mandatory annual audit requirements relating to changes in direct/indirect charging and analysis of sensitive labor accounts (MAARS 7 and 8).

(6) Reorganization/Reclassification of Employees

The organizational structure of the contractor should be analyzed to determine if it permits inconsistent treatment of similar labor. In some instances, reorganizations and reclassifications are implemented to achieve an accounting objective that was not possible under the previous structure. Sufficient review should be performed to determine if the changes will have an impact on government contract costs.

(7) Adjusting Journal Entries/Exception Reports (Labor Transfers)

Determine if there are any unusual labor transfers made via adjusting journal entries. Adequate rationale and supporting documentation should be available for all significant labor transfers. Review in this area requires the auditor to be knowledgeable about how adjusting entries are put into the system, either manually and/or by computer. If some significant entries appear to be more than just normal corrections, the government risk and vulnerability is high and the area

should be reviewed. Reviews in this area may satisfy the mandatory annual audit requirement relating to labor adjusting entries (MAAR 10).

(8) Budgetary Controls

Many contractors operate management systems that require strict adherence to budgetary controls. If the system is inflexible, labor charges may have a tendency to follow the identical route of the budgeted amounts, especially if managers' bonuses or incentives are determined based on performance against some predetermined budget. Rigid budgetary control systems can result in predetermined labor charges. Refer to the review of the contractor budgets as described in Chapter 5-500.

(9) Contract Definition Contracts

Contract Definition (CD) contracts are generally fixed-price contracts for a short duration. They are usually awarded to several contractors who will compete for a major follow-on prime contract. The procurement activity will use the results delivered under the CD contracts to help define exactly what it wants in the prime contract and then issue an informative RFP. Since the contractor's performance on the CD contract will have a direct bearing on its chance of winning the prime, there may be a tendency to spend more than the established contract value. Therefore CD contracts are highly susceptible to labor mischarging and the auditor should review them to make sure all allocable effort is being charged.

(10) Contract Provisions

Any contract or contract modification may contain certain provisions which increase the incentive for labor mischarging. A common example of such a provision is one which puts ceilings on certain cost elements or rates. Similarly, Time and Material/Engineering and Technical Services contracts may include task order funding ceilings which are enforceable when contract language so provides. These ceilings prohibit the contractor from recovering any costs incurred above these preestablished limits. The existence of costs incurred in excess of ceiling limitations should alert the auditor to possible improper cost transfers. Another example of a contract provision which increases the risk of labor mischarging is

a "Cost Sharing Clause." Such clauses may require the contractor to deliver goods and/or services at no costs to the government.

(11) Labor Accounting by Funding

Labor accounting by funding is the controlled management and charging of labor costs to cost objectives on the basis of available funding rather than where the labor efforts are actually performed. Time and Material/Engineering and Technical Services contracts possess a risk of labor accounting by funding. The availability of contract funds often controls where labor costs are charged. To the extent that this practice is employed, the procedures utilized in risk and vulnerability analysis will have to be adjusted because extensive labor accounting by funding often results in no "red flag" conditions since all cost objectives will show labor costs at or below funded levels. The auditor must be alert to this type of situation and consider factors other than cost in determining the existence or extent of this practice. For example, a review of recent deliveries made on government contracts could reveal that no labor costs were charged to a contract during the period when deliveries occurred. Auditor initiative and imagination are important ingredients during an assessment of possible labor accounting by funding problems.

(12) Related/Similar Cost-Type and Fixed-Price Procurements

This situation is fairly common and occurs when procuring agencies award contracts for the same or similar items using different contract types. It represents a high risk condition and should be closely monitored. This situation can often result in some form of "labor accounting by funding," i.e., labor cost to the contracts involved are charged based on contract funding and ceilings regardless of where they are incurred.

(13) Offsite Locations

Significant amounts of labor costs may be incurred at contractor offsite locations where little or no audit effort has been expended. The performance of offsite labor reviews usually requires audit assistance from other FAOs. The determination of risk and vulnerability will require at least oral coordination between the

home and offsite auditors. Requests for assist audits should be prepared and tracked in accordance with 6-801.1.

(14) Labor Charging versus Estimating

A review in this area may reveal that the contractor is charging certain categories of labor directly to government contracts contrary to the manner in which the cost was reflected in the bid proposal or the treatment accorded commercial contracts. The auditor should ascertain the reason for any divergence in policy. Such practices should be further analyzed.

(15) Fixed-Price Sole-Source Follow-On Contracts

Contractors may be motivated to charge effort allocable to commercial work to their sole-source contracts in order to increase the cost of these contracts, which are then used as a basis for projecting the cost of follow-on work.

6-404.7 Determining Additional Audit Effort

a. Use the results of the review of the contractor's labor charging and allocation system and related internal controls, including the contractor's own monitoring and testing efforts, to determine the nature and extent of further audit effort.

b. The analysis of the conditions in 6-404.6, together with the results of the review of internal controls, may identify areas with a high risk of labor mischarging. To best utilize available audit resources, focus audit effort on those areas in which the government's vulnerability and risk are high. For high-risk areas, sufficient review and analysis should be performed to assure that the government's interest is protected. Discuss the results of the analysis with the audit supervisor and adjust the scope of the audit appropriately. As an example, the analysis may reveal the following conditions indicating high risk areas.

(1) The contractor has an over-run/behind-schedule fixed-price contract that is being worked on by a department that also has responsibility for a cost-type contract. The cost-type contract is currently under budget. The effort expended under the two contracts is similar. The ACO and PCO have expressed their concerns and dissatisfaction with the

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contract performance to the contractor. In addition, the department manager's bonus is dependent upon adherence to contract budgets. In this case, the risk area is all employees assigned to the department.

(2) The contractor has an offsite facility that has two fixed-price contracts and one cost-type contract. One program manager is responsible for the three contracts. The program manager's labor effort on the cost-type contract is charged direct to the contract, while the effort on the two fixed-price contracts is charged indirect to overhead. There is reason to believe that this practice is prevalent throughout the company. In this case, the area of risk is all program manager labor effort regardless of department or cost/profit center.

c. If high risk areas warranting further review are identified, preinterview analysis and employee interviews should be performed in accordance with the procedures in 6-404.8.

d. If the analysis has not revealed any high-risk areas, the auditor should consider performing a floor check to satisfy the mandatory annual audit requirement for labor interviews/floor checks (MAAR 6), as discussed in 6-405.3.

6-404.8 Preinterview Analysis

Once high risk areas have been identified for review, perform a preinterview analysis to identify the population of employees associated with the high risk areas, e.g., a cost/profit center, department, contract or cost objective, class of employees, etc., and to select employees to be interviewed. The employee population is usually all employees charging and/or assigned to the risk area. From this population, specific employees will be selected for interviews. Sufficient data must be gathered so that an informed decision can be made on the selection of employees. The employees with the most questionable labor charges are normally interviewed. Just as the risk and vulnerability analysis started with the contractor's entire labor system and narrowed the audit scope to selected areas of risk, preinterview analysis starts with all the employees charging/assigned to the risk area and narrows selected employees

with the most questionable time charges within that risk area.

a. To determine what the high risk population is, the following steps should be performed for each high risk area identified:

(1) Review labor distribution documents and payroll runs to identify all employees charging labor effort or assigned to the risk area. Consider using DATATRAK or other data retrieval programs for this. (See 4-504 for additional guidance on using these programs.) Prepare a schedule of employees charging a major portion of their time to the risk area.

(2) Obtain additional evidential matter by reviewing other relevant available documentation related to the risk area, e.g., organization charts, travel reports, contract files, work authorizations, Material Inspection and Receiving Reports (DD Form 250), contract status reports, etc. Gather as much information regarding the risk area as possible before performing any interviews. For example, if the identified risk area is a certain contract, review enough available documentation to gain an understanding of the scope of contract work, contract delivery schedules, special contract provisions, etc. This review may also identify employees who have worked on the contract but have not charged labor effort to it.

(3) For employees identified in (1) and (2) schedule labor time charges for an appropriate recent period of time. The appropriate time period will vary with each audit. Determine if any significant trends exist. Identify all employees with irregular or inconsistent charging patterns. Focus attention on those employees with the most questionable time charging patterns.

(4) For employees identified in (3), physically inspect timecards (or other source document) starting with the most current time period. Review each timecard for (i) consistent time splitting (be especially alert to employees working multiple jobs in a day), (ii) changes in charging patterns, and (iii) corrections, alterations, white-outs, or indications that someone else is completing the timecard.

(5) For employees identified above, review travel expense reports and compare travel charges to labor distribution charges. Look for inconsistencies.

(6) Gather additional pertinent information on each employee's time charges by reviewing other available documentation. Obtain an understanding of the nature of the work for each contract/cost objective charged during the review period, the time spent on each job including accurate time charging when multiple jobs are worked on a daily basis, and any other relevant information. Also, review CAM Sections 5-1210, 5-1211, and 5-1212 for additional examples or risk areas.

b. Selection of employees for interview should be made as a result of the above review. Select employees whose time charges and review of other documentation indicate a high probability of mischarging. There should be a strong indication that the selected employees have mischarged their labor effort.

c. If no employees in the risk area appear to have questionable time charges, discuss terminating the audit of the risk area with the audit supervisor.

d. An important phase of preinterview analysis techniques is the preparation of adequate working papers. Careful preparation of working papers is critical to the establishment of a basis for effective interviews. Consistency in working paper preparation should be maintained throughout the review. To facilitate review and reference, the working papers should include the employee name and ID number, date of interview, the attendees, the reason for employee selection, an interview summary, and audit conclusion.

e. Data gathered during the preinterview analysis forms the basis for questions asked during the interview. Formulate the questions to be asked each employee and anticipate the responses. The questions should be designed to confirm the employee's suspected mischarging. Keep questions factual in nature; avoid questions which solicit the employee's opinion. Develop a "game plan" for each interview.

6-404.9 Detailed Employee Interviews

Effective interviews and a review of the labor system of internal controls (see CAM 5-900) can provide sufficient information to form an opinion on the adequacy of, and compliance with internal controls and the propriety of the recorded labor charge. Justification for performing detailed employee interviews is provided by GAGAS (see 2-306). The third standard of field work requires that sufficient competent evidential matter be obtained through inspection, observation, inquiry, and confirmation to afford a reasonable basis for an opinion on costs recorded. (See 2-306).

a. The conduct of employee interviews will vary according to the amount and quality of preinterview data gathered. Certain basic steps should be followed when conducting interviews:

(1) Interviews should be performed on a current basis to be effective. Recent events are fresh in the employee's mind and responses to questions on current time charges will usually produce the most reliable audit evidence. However, the auditor is not precluded from asking questions about general time charging patterns that may have occurred over an extended period of time.

(2) All interviews should be conducted at the employee's work location because documentation is readily available.

(3) The interview team should be comprised of two auditors: one interviewer, one recorder. The recorder is expected to ask pertinent questions overlooked by the interviewer. In addition, a contractor representative should accompany each team (see 6-404.3c(3)).

(4) The contractor should not be advised ahead of time about the specific department or individuals to be interviewed. Advance notice of time of the interviews or the employees to be interviewed will not be given.

b. The length and complexity of the interview will vary with the number and types of discrepancies disclosed during preinterview analysis. There is no questionnaire used. Questionnaires may raise problems regarding distribution to employees and access requests by contractors. However, below is a list of certain

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general information that will be elicited from each employee interviewed:

(1) Employee's name and identification number.

(2) Employee's current job title, position description, and nature of his or her work.

(3) Employee's current projects and the period of performance.

(4) Description of the nature of work performed during the period under review.

(5) Percentage of time worked on each project.

(6) The charge numbers/accounts used to record their effort on each job.

(7) How and from whom work authorizations and charge numbers are obtained.

(8) Employee's timekeeping procedures, including maintenance of informal logs.

(9) Any other relevant information resulting from employee responses or observations at the employee's workstation.

c. Listen and record the employee's complete response and be alert to any comments or reactions that seem inconsistent. Ask appropriate follow-up questions.

d. Obtain any available documentation from the employee substantiating the labor effort. Documentation may include final reports, trip reports, drawings, working papers, inventory tags, etc.

6-404.10 Development of Findings

a. Data gathered during the interview, compared with information obtained in the preinterview analysis will either confirm the employee labor mischarge or establish the propriety of the charge. Labor mischarges confirmed during interviews should be discussed with the audit supervisor and, if an assist audit, with the requesting FAO. Sufficient review should be performed to determine if the mischarge represents an isolated instance or is indicative of a more widespread condition. Determine if more audit effort (interviews) is needed to support the audit conclusion. All conclusions must be fully documented.

b. Each risk area should be treated independently. This approach results in a

more effective review and diminishes the chance of wasting time during the review.

c. Determine any costs questioned related to labor mischarges. Costs questioned should be specifically identified (contract, department, cost center, etc.) to each risk area.

6-404.11 Reporting Results

a. Effective labor audit reports succinctly summarize the major audit findings, provide documentable facts of the conditions found, suggest actions necessary to correct the condition, and provide the contractor's reaction and appropriate auditor response.

b. Conduct an exit conference in accordance with 4-304 only after approval of the supervisory auditor. Include the contractor's reactions in the working papers and the report. To ensure all pertinent data has been considered, discuss the findings and recommendations with the contracting officer before the report is issued.

c. Follow the format in 10-400 for reporting problems with procedures and controls, but use the wording/format in 10-805 for reporting CAS/FAR noncompliances.

d. If deficiencies have been disclosed and/or recommendations are presented in the report, schedule a follow-up review to be performed within a reasonable period of time. In the case of serious timekeeping deficiencies, followup will be within three months to ensure corrective action was taken.

e. During the course of the audit, the auditor may become aware of conditions which may indicate fraudulent or other suspected irregular activities as defined in 4-702.1b. Promptly report these as described in 4-702.4.

6-405 Observations of Work Areas (Floor Checks) Procedures**6-405.1 Audit Objectives**

a. The audit objectives include: (1) an evaluation of the contractor's compliance with its internal controls and procedures to insure the reliability of employee time records and (2) the physical observations (floor checks) of work areas to determine

that employees are actually at work, that they are performing in the assigned job classification, and that the time is charged to the appropriate job.

b. Floor check procedures are appropriate when there is limited government risk or vulnerability. If conditions indicating a high probability of mischarging exist, a comprehensive analysis of labor charging and allocation, including employee interviews, as described in 6-404 is appropriate.

c. The performance of floor checks will satisfy the mandatory annual audit requirement relating to labor floor checks (MAAR 6). This MAAR is classified as concurrent and must be performed for the current year during the first field visit to the contractor facility within the year. This will normally be accomplished during a price proposal review, or annual incurred cost audit, or within a specific labor audit assignment. Floor checks must be performed at least annually except for very small contractors which require no other field visits within the year.

d. The extent and frequency of additional floor checks should depend upon the adequacy and reliability of the contractor's system for controlling the accuracy of time charges, materiality, internal controls, the frequency and effectiveness of floor checks by contractor personnel, and the results of previous floor checks.

e. Floor check procedures include reviewing the contractor's timekeeping procedures, selecting employees to be floor-checked, gathering background data, performing the floor checks, and summarizing the results.

6-405.2 Procedures for Reviewing Timekeeping Controls

Obtain an understanding of the contractor's timekeeping procedures prior to performing floor checks. Consider the results of the review of the control risk assessment documented in the internal control audit planning summary and the review of internal controls relating to timekeeping (see 5-900). The review of timekeeping procedures should include the following procedures:

a. Establish the validity of the time records by observing the contractor's

timekeeping system in operation. This includes an observation and evaluation of the method for recording time and periodic physical observations of the work areas.

b. Determine whether employee attendance is controlled by clock cards, time-cards, or other suitable time and attendance records and review contractor's procedure for checking employee early leave and late arrival.

c. Review and evaluate the system by which employee time records are controlled at each timekeeping station, including assignment of job numbers for tasks performed. If job cards are completed by employee, evaluate procedures for notifying the worker of the assigned job number. Determine whether procedures provide that all changes are properly initialed by the employee who initially prepared the time ticket or job card and the approving supervisor.

d. Determine whether hours shown on time tickets or job cards are reconciled periodically with the hours recorded on attendance records and the total hours recorded on the payroll.

e. Determine whether there is a division of responsibility between personnel responsible for the preparation of time and attendance records and those responsible for the preparation and distribution of the payroll.

f. Determine whether there is a division of responsibility between personnel having a part in the preparation of time and attendance records and those responsible for operating within budgets.

g. Determine whether procedures have been established for coding and recording idle time. The auditor should review or prepare an analysis of idle time according to the reasons for idle time such as waiting for inspection, lack of materials on hand, etc., and ascertain whether the contractor has taken corrective action to reduce the idle time.

h. Determine whether records of piecework and work performed under wage incentive plans are checked and controlled independently as to production counts, approvals for allowances, and other operations.

i. Perform independent floor checks and test employee attendance and the

accuracy in recording the work performed for all shifts.

j. When appropriate, request representatives of the contracting officer to accompany him or her on floorchecks.

k. Scan batches of labor distribution documents for obvious errors or arbitrary allocations of time to contracts.

6-405.3 Procedures for Performing Physical Observations (Floor Checks)

Floor checks should be conducted in a manner which will least disturb the normal operations of the contractor. When appropriate, other government personnel or contractor representatives may accompany the auditor during the floor checks. The extent and frequency of floor checks should depend upon the adequacy and reliability of the contractor's system for controlling time, internal controls, the frequency and effectiveness of floor checks by contractor personnel, and the reliability of the records indicated as a result of floor checks. Consider the procedures described below in conducting a floor check.

a. Identify the population of employees by obtaining a control list of persons assigned to the department or area to be checked. A listing of employees by location will be helpful in determining any necessary assist audits. If significant numbers of employees are at offsite locations, consider requesting assist audits (see 6-800). When a common area is used to perform government and other production, a floor check of the government work alone is not sufficient. To establish over-all control, check the entire department, work area, or specific labor category, but when circumstances warrant, emphasize the government portion of the operation.

b. Select employees to be floorchecked. Employees may be selected either randomly or judgmentally, depending upon the audit circumstances and objectives. If chosen randomly, procedures described in Appendix B should be followed.

c. Gather background data relating to the selected employees. Appropriate data may include:

- (1) Employee identification numbers.
- (2) Employee job classifications.

(3) Nature of the work usually performed by the employee and by the department or cost center to which he or she is assigned.

d. Offer the contractor an opportunity to designate a representative to accompany each audit team during the floor checks. A primary and alternate representative should be designated for each of the contractor's locations.

e. Determine the make-up of the floor check team. In high-risk situations, the team should consist of two auditors: one interviewer and one recorder.

f. Ensure that all team members are thoroughly briefed on the overall audit objectives and that they have the necessary background knowledge to contribute to the floor check.

g. Obtain a plant layout and note the location of employees selected for questioning.

h. Floor check the employees selected. The employee's manager should not be present unless it will facilitate accomplishment of the objectives. Try to question all selected employees in a given work area before moving to another. If a particular employee cannot be located, obtain contractor assistance. Note, however, that seeking such assistance has the effect of providing advance notice of the floor check.

i. Identify each selected employee at work in the department or area being observed and check to the control list, showing the time observed. Determine whether the employee is performing in the proper capacity as direct or indirect labor and whether time is being charged correctly by discussing the nature of the work being performed with the employee and observing the actual work performance. If an employee's time for the prior period was charged to a cost code or work project other than the one he or she is working on during the floor check and the nature of his or her work is not such that it obviously entails frequent job changes, the employee should be queried regarding his or her work assignment in the prior period. This procedure may disclose errors, adjustments, or alterations to the prior period labor distribution records which require further analysis.

j. Discuss the employee's timekeeping procedures to determine compliance with established internal controls and to determine if the employee has received adequate orientation and training. Question the employee to ascertain the following:

(1) Procedures for receiving the timecard.

(2) Procedures for receiving work assignment charge numbers and descriptions.

(3) Procedures for completing and submitting the timecard.

k. Listen patiently and attentively to the employee's complete responses to questions. Do not interrupt or answer for the employee nor allow the contractor's representative to do so.

l. Record the employee's complete response and be alert to any comments or reactions that seem inconsistent with question responses.

m. Compare responses with previous data gathered. If inconsistencies arise or further clarification is required, ask appropriate follow-up questions.

n. Obtain explanations promptly (before the close of the shift whenever possible) concerning all questionable procedures or practices observed during the floor check. Determine the reasons for any timekeeping discrepancies noted on the control list, such as: employees at work who are not on the control list, employees on the control list who could not be located, reasons for time being charged to work which is not being performed, reasons for working at other than assigned labor classifications, and reasons for idleness.

o. Determine whether the observations made during the floor check are properly reflected on the payroll and labor distribution records. Advance planning may be required to assure that the records are available in sufficient detail to make this check possible. When the contractor's timekeeping system is automated, special print-outs may be required.

p. With automated timekeeping procedures, additional care must be taken in the design of the floor check and the subsequent comparison to labor distribution records. An automated system uses remote data entry terminals to record labor charging data directly to the com-

puter for processing. Supporting documentation normally consists of machine printouts showing data that, in a manual system, appears on source documents. A computerized system can be programmed to alter the labor cost distribution and prepare printouts to support it. The effect is the same as a manual alternation of records. The computer, however, can do the job more efficiently and without involving large numbers of people. If internal controls over the automated system are weak, consideration should be given to expanding the floor check into a review of labor cost charging and allocation (6-404).

q. Be alert to unusual situations such as employee idleness, extensive use of labor for rework or remake operations, excessive number of workers or inefficient use of workers assigned to government work, lack of appropriate protection of property from theft or the elements, use of maintenance supplies to construct capital assets, unused floor space or equipment, or assignment of the more efficient workers to commercial work while similar government work is being performed by less efficient workers receiving substantially the same rate of pay. Information to substantiate the use of less experienced workers on government contracts may be developed from an examination of personnel records (length of service and background experience), labor tickets, and payroll. When a situation as described above exists, ascertain the reasons for the condition, whether it is permanent or temporary, and whether corrective action is necessary.

r. Discuss the results of the floor checks with the audit supervisor and summarize the results of audit.

s. Report the audit results as prescribed in 6-404.11.

6-405.4 Access to Restricted Areas (Floor Checks)

Occasionally during the course of a floor check an auditor is denied access to an employee, documentation regarding the employee's work, or an area of the contractor's facility due to security reasons. The floor check audit team should not automatically omit selected employees because of these security restrictions.

When access is denied, the auditor should work with the FAO security control officer and the contractor to make arrangements for obtaining special access in accordance with 1-503.1. If it is determined that another audit organization has cognizance of the area, an assist audit request to that organization should be considered.

a. At contractors where both the regular and Field Detachment DCAA FAOs have audit workload, annual coordination meetings are held between the two FAOs to determine the cognizant FAO and discuss the responsibilities of each FAO. During this meeting, the FAOs should discuss suggested procedures to follow where access is denied during a floor check because of security clearance reasons.

b. If there is reason to believe that the denial of access is not based on a government-imposed security restriction and the auditor has the appropriate clearance to obtain access, carefully consider the guidance in 1-504 to determine whether the procedures cited in DCAA Instruction No. 7640.17 are applicable.

6-406 Review of Payroll Preparation and Payment

6-406.1 Audit Objectives

a. The basic audit objectives are to determine (1) the contractor's compliance with its policies, procedures, and internal controls for the preparation of payroll, (2) whether payroll payment procedures afford adequate protection to payroll checks and cash, (3) whether distribution is made to employees named as payee on payroll check or pay envelope, (4) whether there is adequate control over undelivered payroll checks or cash, (5) whether these activities are accomplished in an economical manner, and (6) the integrity of payroll and labor cost records by reconciling payroll accruals and disbursements to cost distribution records.

b. Accomplishment of the above objectives will satisfy the mandatory annual audit requirement related to payroll/labor distribution and tracing (MAAR 9). The extent of audit in this

area will depend on the effectiveness of the contractor's accounting procedures. Thus the early identification of system weaknesses is of prime importance to efficiently satisfy this MAAR.

6-406.2 Audit Procedures

a. Payroll Preparation. The auditor should review: the results of the labor internal controls review, chapter 5-900; and organizational responsibilities to ascertain whether the payrolls are prepared by personnel independent of persons responsible for the timekeeping operation and for the actual payroll payment. In evaluating compliance with the internal controls for payroll preparation, the auditor should be guided by the following procedures:

(1) Ascertain the accuracy of the basic payroll records (clock cards, job tickets, assignment records) and evaluate the method for processing the data.

(2) Review and evaluate the methods used to reconcile the totals of clock cards and job tickets and note changes made in time recorded on clock cards.

(3) Ascertain whether all time adjustments, other than apparent and obvious arithmetical errors, indicate evidence of supervisory review and control.

(4) Ascertain whether pay rates in effect are supported by written authorization from the personnel department or other authorized source.

(5) Determine whether suitable cross checks are maintained within the payroll department for verifying the accuracy of names, rates, hours, extensions, deductions, footing, and accounting distribution.

(6) Reconcile payroll totals (dollar value and hours) with totals of related labor cost distribution records. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records. Completion of this will help satisfy the mandatory annual audit requirement relating to payroll/labor distribution reconciliation and tracing (MAAR 9).

(7) Determine the adequacy of procedures to assure that payroll advances are not charged as a direct or indirect expense.

(8) Test pay rates by reference to labor union or other employment agreements, applicable contract provisions, and contracting officer approvals.

(9) Review and evaluate the methods used for reconciling over-all payments to labor cost distribution records.

(10) Review and evaluate the periodic reconciliations performed by the personnel department from the information submitted by the payroll department.

b. Payroll Payments. In verifying payroll payments, the auditor should observe, on an unannounced basis and in selected areas on a test-check basis, the actual distribution of checks or cash to employees, including the method used to identify employees. The auditor should review the methods for safeguarding pay checks or cash for persons absent on the regular pay date and the procedures for subsequent payment to employees. The auditor should be guided by the following procedures in examining payroll disbursements:

(1) Determine whether all employees are paid by prenumbered checks and whether the contractor accounts for all numbers.

(2) Ascertain whether checks prepared in error are voided by permanent notation and are filed in numerical sequence with the canceled checks. The contractor's procedures should provide for obsolete or surplus checks to be destroyed in the presence of authorized personnel and the destruction evidenced by their signature.

(3) Ascertain the disposition made of unclaimed payroll checks. Where the government has been charged for the cost represented by unclaimed checks, the auditor should determine that costs to the government are properly adjusted, either by payment to the government, by a credit to the accounts originally charged to an overhead account, or in some other equitable manner.

(4) Compare selected names on the payroll with personnel records to establish authenticity of employment and pay rates.

(5) Determine whether the contractor's internal audit staff observes the distribution of payroll checks at unannounced intervals.

(6) Review the manner in which the reconciliation of the payroll bank account is performed, and determine whether it includes (1) examination of endorsements on paid checks, (2) accounting for the numerical sequence of checks, (3) a comparison of checks with the payroll records, and (4) appropriate action to cancel long-outstanding checks. The reviews and reports of this function by the contractor's public accountant and internal auditors should be considered.

6-407 Review of Personnel Policies and Procedures

Review and evaluation of the contractor's personnel policies and procedures should assist the auditor in determining the extent of verification and testing required.

6-407.1 Review and Evaluation of Management Policies

a. The review and evaluation of the contractor's policies and internal controls for (1) hiring, assigning, dismissing, and controlling the labor force, (2) establishing pay rates, rate changes and any additional compensation, (3) establishing attendance and time keeping controls, (4) authorizing and monitoring overtime and multi-shift work by hourly paid personnel, (5) authorizing, controlling, and disposing of compensatory time worked by salaried personnel, establishing vacation, sick leave, and holiday allowances, and (6) establishing and maintaining surveillance over categories for direct and indirect labor classifications is covered in chapter 5-900.

b. The auditor should obtain an understanding of the internal control for personnel records. Effective controls should include as a minimum, the following practices and procedures:

(1) Hiring and dismissal of employees should be approved by responsible company officials.

(2) The personnel department should exercise control over all absences.

(3) Reasonable ranges of compensation should be established for each salary and wage grade.

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(4) Payroll increases or decreases should be approved by a responsible official of the personnel department.

(5) Procedures should be established in the personnel department for the prompt reporting to the payroll department of all changes affecting payroll, such as new hires, rate changes, dismissals, and other employee separations.

(6) Personnel records should be maintained for each employee. The records should be independent of the payroll department and should include information such as the date of employment, pay rate, classification, terms of employment, personal history, and approval for hire.

(7) The payroll department should compile a listing of all employees by class, department assigned, and pay rate. This information should be forwarded periodically to the personnel department for reconciliation with its records.

6-407.2 Evaluation of Advance Planning Procedures

The auditor should evaluate the contractor's plan for establishing the proposed level of operations and should review all significant contemplated increases or decreases in labor costs. When marked increases in production are planned, the auditor should review the contractor's plans for lead time in hiring, training, and utilizing additional personnel. When necessary, the auditor should seek the opinion of qualified government technical personnel. Improper lead time may generate unwarranted costs either by hiring personnel in advance of need (considering the training period) or by not hiring soon enough and thereby disrupting the production line. When the contractor contemplates a cut-back in production, and a consequent decrease in personnel, the auditor should evaluate the contractor's plan for decreasing personnel and determine whether the contractor is retaining the higher salaried technical and supervisory personnel beyond the required period at an increased cost to the government. The auditor should ascertain also that direct labor personnel who should be terminated are not transferred to duties of an indirect nature without justification. This is particularly important when the government

is sharing substantially in the contractor's indirect expenses. These procedures will satisfy the mandatory annual audit requirement relating to changes in direct/indirect charging (MAAR 7).

6-407.3 Evaluation Guidance

In evaluating the contractor's personnel practices, the auditor should include, but not limit his review to, the following:

a. A review of the corporate minutes generally record top-management decisions which affect personnel policies. (In multi-plant operations, this review is usually made by the Contract Audit Coordinator or the auditor of the corporation home office.) This will help satisfy the mandatory annual audit requirement relating to direct/indirect charging (MAAR 7).

b. A review and evaluation of the current written operating procedures which apply to personnel activities.

c. A review of the actual practices followed at the operating levels and a comparison of these practices with the written procedures.

6-407.4 Review of Procedures for Determining Personnel Requirements

The auditor should evaluate the procedures by which the contractor determines the required number and classification of personnel. When contractors have been producing under government contracts over an extended period of time at approximately the same level of operations, requirements usually are based on personnel turnover experience. When a program is undergoing expansion or when the contractor has been awarded a contract for the first time, determination of the number, type, and quality of personnel required is usually based on the contractor's estimates. The auditor's evaluation of the contractor's basis for determining personnel requirements should include, as a minimum, ascertaining (1) that the policies are sound, clearly stated, and generally applicable to a prudently operated business, (2) that the request for personnel is approved by a responsible executive, and (3) that when a request for additional personnel is submitted it is supported by valid reasons

and management has considered all other alternatives before granting the request.

6-408 Review of Recruitment Costs and Practices

6-408.1 Area of Coverage

The recruitment of most employees is a function of the personnel department. Costs incurred include (1) help wanted advertising, (2) salaries and travel expenses of company personnel engaged in recruiting efforts, (3) travel and living expenses of applicants and new employees, (4) expense of moving household effects of new employees, and (5) fees paid to employment agencies.

6-408.2 Audit Objectives

The audit objectives are to establish whether (1) the contractor's recruiting policies, procedures, and practices are acceptable, (2) the program is effectively administered, and (3) the total cost is reasonable in comparison with the results achieved and appropriately allocated.

6-408.3 Audit Procedures

In accomplishing the audit objective, the auditor should be guided by the procedures described below:

a. Review the prescribed duties and responsibilities assigned to the organizational unit responsible for recruitment activities and ascertain that they are clearly established to accomplish the assigned mission.

b. Review recruitment activities for the most recent operating period and obtain, among other information, data on:

(1) Employment changes during the period under review (new hirings, transfers, separations) to determine the rate of turnover by classes of employees.

(2) Recruitment efforts (applicants interviewed and employment offers made, accepted, and rejected).

(3) Sources of new hires (advertising, referrals, and employment agencies).

(4) Total costs of recruitment (advertising, salaries, travel expense of contractor personnel and recruits, relocation expense, and employment fees). The auditor should review or develop data on the

cost per hire, and by type of hire, such as engineers or executives.

c. Review the various types of payroll allowances or fringe benefits to employees. Determine whether allowances are in accordance with established company policy and whether they are reasonable in view of standard industry practices and criteria for determining reasonableness contained in procurement directives.

d. Ascertain the nature and extent of budgetary controls exercised over the cost of different types of recruiting methods used and allowances paid employees.

e. Compare employee turnover rates being experienced for various categories of personnel with prior years' rates and with rates anticipated by management. Consider the effect of the turnover rates on the continued need for large scale recruitment activities; or conversely, the need to reduce these activities significantly. Ascertain if measures are being taken to identify and eliminate the causes of the turnover.

f. Review the extent to which recruitment is controlled by manpower forecasts, specific job requisitions, and by management approval.

g. Evaluate procedures used to recruit qualified technical personnel to meet work requirements.

6-409 Review of Overtime, Extra-Pay Shifts, and Multi-Shift Work

The auditor should review the contractor's policies, procedures, and internal controls on overtime, extra-pay shifts, and multi-shift work, and the accounting and distribution of the premium costs. The auditor should be familiar with the provisions of FAR 22.103, which includes definitions and conditions under which overtime costs may be approved under government contracts. When overtime work is required, the contractor's policies and procedures should comply with FAR 22.103 and insure that the operations will be limited to the actual need for the accomplishment of specific work. The auditor should ascertain that the amount of work performed at premium rates is equitably divided between government and commercial operations.

6-409.1 Audit Objectives

The objectives of audit are to determine whether (1) management is properly authorizing, scheduling, and controlling overtime, extra-shift, and multi-shift work, (2) the contractor is obtaining the contracting officer's written approval when required by contract provisions, (3) the premium costs are reasonable and properly allocable to the government contracts, (4) adequate control is exercised over productivity in the extra-pay periods, and (5) compensatory overtime work by salaried personnel is properly authorized, and application against subsequent working hours is properly monitored.

6-409.2 Audit Procedures

Audit procedures should include the following:

a. A determination as to whether the contractor's practices are consistent with the government's interests. Effective procedures should include (1) acceptable standards to determine the need for overtime and premium shift work, (2) the establishment of categories of employees eligible to receive premium pay, (3) the proper levels of management authorization, approval, and continuing control over these operations, (4) the establishment of adequate procedures for authorizing compensatory overtime and effective monitoring of compensatory overtime credits against subsequent working time not actually worked, and (5) the continual review of overtime and shift data by management to control overtime and shift premium costs.

b. A review of contracts, when overtime and shift work is applicable, and an examination of the bid proposal and negotiating memorandum to ascertain the extent to which the contract price provided for overtime premium and shift premium expenses. If overtime and shift premiums were not considered in the contract price, the auditor should ascertain and evaluate the reasons for the overtime and shift premiums.

c. A determination that premium labor costs charged to the contract have been approved by the contracting officer, when required, and have been incurred in

accordance with the contractor's normal policy.

d. A periodic review of the continuing need for the exception types of overtime operations cited in FAR 22.103-4/DFARS 222.103-4.

e. A review of the accounting treatment accorded overtime premium pay and the method of cost distribution. Overtime premium pay, although generally treated as indirect expense, may be acceptable as a direct charge when it is the contractor's regularly established policy and when appropriate tests clearly demonstrate that this policy results in equitable cost allocations.

f. A review of the accounting and distribution treatment accorded shift premium pay.

g. A review of the contractor's procedures for compensatory overtime work to determine that this type of work is properly authorized and performed according to an acceptable company policy and that proper monitoring is exercised by management in applying an employee's compensatory overtime to subsequent scheduled working time in which the employee does not work.

6-410 Review of Uncompensated Overtime**6-410.1 Introduction**

a. The Fair Labor Standards Act (FLSA) requires employers to compensate hourly workers for hours worked in excess of 40 hours per week, but the FLSA does not require employers to pay overtime to salaried employees. Salaried or exempt employees are paid a salary to provide a service. The salary (weekly, monthly, or annual) is based on providing that service in whatever time is required. Therefore, exempt employees are compensated for all hours worked including those worked beyond the normal 40-hour week. However, because most contractors' accounting systems account for labor based on a 40-hour week, the hours worked in excess of the normal 40 hours per week are commonly called uncompensated overtime. In April 1991 a new solicitation provision and contract clause, DFARS 252.237-7019, Identifica-

tion of Uncompensated Overtime, was issued which defines uncompensated overtime as "hours worked in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act (FLSA), without additional compensation." See 9-505.

b. Many contractors' accounting systems do not assign costs to those hours worked by exempt employees in excess of 8 hours per day or 40 hours per week. In some cases, labor costs are distributed only to cost objectives worked on during the first 8 hours of the day. In other cases, employees are permitted to select the cost objectives to be charged when more than 8 hours per day are worked or the contractor has an informal policy as to how employees should select the objectives to charge. For example, when a contract and B&P project are worked on the same day, the actual hours incurred on the contract might be charged first and the balance up to 8 hours might be charged to the B&P project. Obviously, there is serious risk of mischarging costs to government contracts under such circumstances.

6-410.2 Audit Objectives

The basic audit objectives are to determine (1) whether the contractor is accounting for all hours worked; (2) whether the contractor is allocating an equitable share of salary costs paid to all effort performed in accordance with FAR 31.201-4; and (3) whether all work accomplished, including that using excess hours worked by exempt employees, is included in the base for distribution of overhead costs in accordance with CAS 418.

6-410.3 Basic Audit Procedures

a. Review the contractor's policies and procedures relative to work performed by exempt employees in excess of 8 hours per day or 40 hours per week. For service contracts to be awarded on the basis of the number of hours to be provided, DFARS 252.237-7019 requires an offeror to submit a copy of its policy addressing uncompensated overtime with its proposal. In addition, this DFARS requires that an offeror's accounting practices used to estimate uncompensated overtime be

consistent with its cost accounting practices used to accumulate and report uncompensated overtime hours. See 9-505.

b. Determine whether the contractor is recording all hours worked by exempt employees. If a review of the employee time records discloses that exempt employees consistently record only 8 hours per day/40 hours per week, conduct floor checks and/or employee interviews to see whether exempt employees work in excess of 8 hours per day or 40 hours per week. If they do, discuss with contractor representatives the need to record all hours worked by exempt employees in order to ensure that salary and applicable indirect costs are being equitably allocated to all effort performed by the employees during the period. If the contractor refuses to record all hours worked by exempt employees, expand the floor checks and employee interviews to determine whether the failure of the contractor to record all time worked results in a material difference in the allocation of costs to final cost objectives. Obtain the assistance of the contracting officer in requiring the contractor to record all hours worked when a material difference in allocation of costs is determined.

c. Determine whether the contractor is allocating salary costs paid to exempt employees to all effort performed in accordance with FAR 31.201-4 and CAS 418.

d. If it is determined that government contracts are being over charged by a material amount due to an inequitable allocation of costs because the contractor does not record all time worked, the contractor should be cited as being in noncompliance with FAR 31.201-4 and CAS 418. Any material excess allocation of costs to government contracts should be questioned or disapproved as applicable. Materiality, as discussed in CAM 10-103.3j(2), is the governing factor when determining whether noncompliances should be cited and whether a contractor should be required to implement a total-hour accounting system.

6-410.4 Acceptable Accounting Methods

Accounting for excess hours worked by exempt employees may be accomplished by a variety of methods, including:

76-410.4a.

a. Computing a separate average labor rate for each labor period, based on the salary paid divided by the total hours worked during the period, and distributing the salary cost to all cost objectives worked on during the period based on this rate.

b. Determining a pro rata allocation of total hours worked during the period and distributing the salary cost using the pro rata allocation. For example, if an employee was paid on a weekly basis and worked 25 hours on one cost objective and 25 hours on another cost objective, each cost objective would be charged with one-half of the employee's weekly salary.

c. Computing an estimated hourly rate for each employee for the entire year based on the total hours the employee is expected to work during the year and distributing salary costs to all cost objectives worked on at the estimated hourly rate. Any variance between actual salary costs and the amount distributed is charged/credited to overhead.

6-410.5 Other Possible Accounting Methods

Other methods of accounting for excess hours worked by exempt employees may be used by the contractor, some of which would be unacceptable and others of which would require further review to determine acceptability. Examples of these methods are (1) distributing the salary cost to all cost objectives based on a labor rate predicated on an 8-hour day/40-hour week and crediting the excess amount distributed to overhead; and (2) determining a pro rata allocation of hours worked each day and distributing the daily salary cost using the pro rata allocation (use of daily distribution increases the possibility for "gaming"). Evaluation should be made of the method used by the contractor to determine the significance of any inequities which may result.

6-411 Review of Other Labor Costing Systems (Standard Cost and Sole Proprietors'/Partners' Salaries)

a. Standard Cost System. The use of standard costs (when variances are ap-

propriately applied) to record direct labor costs for government contracts is acceptable, particularly when the operations among several government contracts or the operations between government and commercial production are similar and are so intermingled as to unduly complicate the actual cost accounting processes. Use of a standard cost accounting system to cost government contracts is permitted only when it meets the criteria in CAS 407 (see 8-407).

(1) In accepting standard labor costs, the auditor should determine the extent to which collateral labor costs such as overtime, shift premium, sick leave, and vacation pay are included in the established standard.

(2) The auditor should determine whether standards are based on formal, scientific and reasonably current studies representative of actual operations performed. The auditor should trace standard labor charges from distribution sheets to the payroll records to determine whether recorded standard operations for a given date or period conform to the actual operations for which payment was made to employees.

(3) The auditor should test related variances to product line to determine whether standards and variances approximate actual costs.

(4) The auditor should also analyze variances, preferably by reviewing contractor's own analyses, to find the causes of variances (for example, rate, efficiency, down time, or setup). This may disclose improper charges to direct labor through the variance accounts.

b. Sole Proprietors' and Partners' Salaries. Sole proprietors' and partners' salaries usually are included in overhead. However, when owners or partners are personally engaged in performing under government contracts, particularly in research and development contracts, their compensation may be charged as direct labor. The review of time charged directly should be coordinated with the screening of other direct and indirect labor to prevent duplication of charges in direct and indirect labor. It may be more appropriate in some instances to treat the compensation of proprietors and partners as Other Direct Costs without overhead.

The auditor should evaluate the reasonableness of the compensation charged on the basis of services rendered. Proprietors and partners time charged direct will also influence consideration of profit or management return. When the rate of pay has not been stipulated in the contract, the auditor should evaluate the reasonableness of the rate. The auditor should ascertain whether acceptable time records are available to substantiate the time charged to the contract. When the amount of time spent on the contract is significant, all of the individual's time should be accounted for and not only that portion of time charged to the contract. The services of a government technical representative should be solicited when the auditor is unable to evaluate the reasonableness of the charge because of technical considerations.

6-412 Evaluation of Quantitative and Qualitative Utilization of Labor

6-412.1 Audit Objectives

The basic audit objectives are to evaluate the internal controls instituted to assure prudent utilization of staffing in the performance of government contracts, to determine whether the costs are commensurate with the benefits derived, and to determine the reasonableness and efficiency of the labor utilization.

6-412.2 Audit Procedures

To accomplish the audit objective, the auditor should be guided by the procedures described below. The evaluation of the quantitative and qualitative utilization of labor may require the assistance of qualified government technical personnel. The auditor should go as far as he or she can in each audit step pending technical review and analysis. When the issuance of an audit report would otherwise be unduly delayed because the technical analysis is not available, a qualified report should be issued. The auditor should identify manpower utilization reviews performed by the contractor or others and consider the results in completing the following audit procedures.

a. Review the contractor's functions and related activities for quantitative and

qualitative utilization of labor. The review should disclose organizational and functional areas which require audit emphasis.

b. Ascertain whether the work performed by the contractor is required by the terms of the contract, properly authorized, and directed to the appropriate operational unit.

c. Determine whether there are unwarranted variations between staffing budgets allocated by upper management and staffing budgets actually used by operating or middle management. (See 5-500 for guidance on contractor budgeting procedures.)

d. Determine whether the contractor maintains adequate control over the expenditure of the technical effort to assure maximum productivity, whether this control includes the evaluation of actual work assignments and target completion dates, and whether comparisons are made with staffing budgets and staffing tables approved by management.

e. When salaries and wages constitute a significant portion of contract costs, review and evaluate, on a selective basis, personnel files of employees assigned to government contract work to determine whether qualifications of workers performing the contract are commensurate with the rates charged and all other requirements of the contract.

f. Review the contractor's personnel practices during start-up and phase out periods to determine whether the cost of excess personnel is charged to government contracts in the build-up period and whether the government contracts are unduly burdened with the retention of unnecessary personnel in the phase out period.

g. Review the contractor's basis for assigning and phasing out technical personnel for both government production and commercial operations. Audit emphasis should be accorded the phase out portion of the contract to determine the reasons for retaining certain classes of technical personnel to complete the contract. The auditor should also determine whether the contractor is assigning technical personnel in accordance with their skills. The use of highly trained personnel to perform routine work which could be

76-412.2g.

performed by lower paid personnel is not economical. The use of less than qualified personnel to perform difficult work may result in higher costs to the government because more time and greater supervision may be required. The type of contract should be a guide to the auditor in determining the extent of verification in these areas.

h. Examine the contractor's staffing and labor control practices to determine the effectiveness of controlling idle time. If unreasonable idle time is perceived or controls are judged to be inadequate, conduct a preliminary work sampling (probe). Work sampling is described in Appendix I.

i. Compare labor classifications charged to the contract with those proposed to ascertain whether the contractor is utilizing the type of personnel for which the government has contracted.

j. Determine whether engineering, technical writing, etc. on government work is subcontracted rather than performed by the contractor and whether such practice results in unreasonable costs to the government. Among the factors to be considered is whether, under the prevailing conditions, there is any necessity for subcontracting other than to meet temporary or emergency requirements. (See 7-1900 for further guidance in this area.)

k. Review manual labor procedures for possible mechanization (capital investment opportunities, 14-600) which will result in increased efficiencies and economies of the contractor's operation and less cost to the government.

6-413 Reasonableness of Compensation Costs

The guidance contained in this subsection is designed to assist the auditor in determining the reasonableness of employee compensation costs in accordance with the criteria set forth in FAR 31.205-6, Compensation for Personnel Services. The review of the compensation system and related internal controls is covered in 5-800. The scope and extent of any testing for reasonableness should be based on the control risk assessment and

results of the review of internal controls over compensation.

6-413.1 Compliance with FAR 31.205-6(c), Labor-Management Agreements

a. All compensation paid in accordance with an "arm's length" negotiated labor-management agreement is considered reasonable unless the provisions of the agreement are either unwarranted or discriminatory against the government per FAR 31.205-6(c). That is, it will not be tested for reasonableness under FAR 31.205-6(b). But it must, nonetheless, satisfy any specific compensation element allowability criteria elsewhere in FAR 31.205-6.

b. Unwarranted or discriminatory provisions exist when, under unique circumstances, the work conditions vary significantly from those contemplated by the negotiating parties, or the collective bargaining agreement contains provisions that are inequitable to the government as a class of customer by the character and nature of the work.

c. Arm's length agreements refer to those agreements between independently organized labor groups such as labor unions and contractor management for the purpose of establishing wage increases, hours, benefits, and working conditions.

d. Provisions of an agreement designed to set pay rates based on a given set of circumstances and conditions of employment such as work involving extremely hazardous activities are unwarranted if the work on government contracts is less hazardous.

e. Provisions of an agreement are considered discriminatory against the government as a class of customer when the agreement mandates pay provisions for work of the same character and nature that exceed those comparable to similar commercial work. Therefore, an agreement with provisions which require higher pay levels for contractor employees who work on government contracts than for those contractor employees performing under the same conditions on commercial contracts is discriminatory. For example, a union agreement that provided for higher wage rates for construction work on a government installation than

for rates applicable to commercial construction in the same area under similar circumstances would be considered discriminatory.

f. Compensation costs resulting from labor-management agreements determined unwarranted or discriminatory against the government should not be disallowed per FAR 31.205-6(c) unless "(1) The contractor has been permitted an opportunity to justify the costs; and (2) Due consideration has been given to whether unusual conditions pertain to government contract work, imposing burdens, hardships, or hazards on the contractor's employees, for which compensation that might otherwise appear unreasonable is required to attract and hold necessary personnel."

6-413.2 Evaluation of the Reasonableness of Nonunion Compensation per FAR 31.205-6(b)

a. FAR 31.205-6(b)(1) states:

In administering this principle, it is recognized that not every compensation case need be subjected in detail to the above or other tests. The tests need be applied only when a general review reveals amounts of compensation that appear unreasonable or unjustified.

b. Should the results of review of the contractor's compensation system (see 5-800) determine that significant deficiencies exist, specific testing for the reasonableness of the compensation resulting from the system should be conducted under FAR 31.205-6(b)(1). If it is determined that the contractor has established and maintained a sound compensation system, it should not be necessary to apply the tests of reasonableness per FAR 31.205-6(b)(1), unless warranted by specific policies or procedures that appear to promote unreasonable costs, such as the contractor's pay policies require that pay levels significantly exceed average labor market pay levels without justification. Before taking exception to compensation costs, consider the reasonableness test procedures as discussed in this subsection. Compensation costs subject to CAM 6-414 should not be accepted on the basis of compensation system reviews without some testing to substantiate the reasonableness of the compensation.

c. When evaluating wage increases, if the compensation system is adequate, and the contractor's established practice is to provide wage increases to certain nonunion employees comparable to those given union employees, no tests of reasonableness need be applied.

d. Each allowable element making up an employee's compensation package must be reasonable per FAR 31.205-6(b)(1). Compensation must be reasonable for the work performed as evidenced by consideration of relevant facts to include general conformity with the compensation practices of other firms of the same size, other firms of the same industry, other firms in the same geographic area, other firms engaged in predominantly non-government work, and with the costs of comparable services obtainable from outside sources. [For compensation paid in accordance with a labor-management agreement, refer to 6-413.1].

6-413.3 Application of Reasonableness Tests

To apply the FAR reasonableness tests, the contractor's wages and salaries are to be compared with the wages and salary data of other firms that meet the criteria described in subsection 6-413.2. The most likely medium for obtaining the wages and salary data will be market pay surveys. When market pay survey data are used in making the FAR comparison tests, identification of the firm participants and their qualifications to meet the FAR criteria is required and should be documented in the audit working papers. For example, to meet the geographic area factor for a contractor located in Los Angeles, the pay survey used must state that the geographic location of the participating firms is also Los Angeles. This information should be documented.

a. FAR 31.205-6(b)(1) states that in determining the reasonableness of individual compensation elements consideration should be given to all potentially relevant facts. These facts include general conformity with the practices of firms of the same size, in the same industry, in the same geographic area, firms engaged in predominately non-government work,

and the cost of comparable services from outside sources.

(1) Geographic area refers to comparisons made with firms in the same locale or regional area as that of the contractor.

(2) Size pertains to comparisons with firms of relatively the same size in terms of number of employees or sales volume. Sales volume is a factor in evaluating executives' compensation.

(3) Industry means comparisons with firms producing similar products or providing similar services. For instance, the compensation levels for a contractor whose principal product is shipbuilding should be compared to other shipbuilders. Other industries include aerospace, electrical/electronics, office equipment and computers, or research and development. The contractor's specific industries may be identified by reference to the government's Standard Industrial Classification (SIC) codes which are used to classify companies by industry. The SIC codes can be found in item 1.3.0. of the contractor's Cost Accounting Standard disclosure statement. (However, this item has been removed from the revised disclosure statement form dated March 1992.) It should be noted that compensation survey data for several related SIC codes is often presented in aggregate to represent a group of industries commonly categorized for example as aerospace industries.

(4) Contractor's compensation levels should be compared to firms that are engaged in predominantly non-government work, that is firms with non-government annual sales of 50 percent or greater.

(5) For services such as janitorial services which may be readily provided by outside contracting services, comparisons of related compensation levels should be made with the costs of comparable services from sources outside of the contractor. This test should be considered equally with other tests.

b. All factors may not be relevant to the same extent; therefore, all factors must be considered in order to determine their relevance. Relevance is directly tied to a contractor's circumstances as explained in 5-808.3(c). Rationale for the determination of the significance of the relevant

factors to be applied must be sufficient to address the considerations of reasonableness as set forth in FAR 31.201-3 (see 6-413.5)

c. Acceptable wage or salary surveys to be used for applying the FAR tests should provide the appropriate relevant factor data as outlined above to make the comparisons and should be determined reliable as provided in 6-413.4. An acceptable survey(s) may include firms that represent more than one of the relevant factors such as firms that are of the same size, geographic area, and industry as the contractor.

d. Make comparison tests with benchmarked jobs within a pay structure grade (see 5-808.1) or equivalent. Tests are to be made by comparing the weighted average wage or salary of a job with those provided in an acceptable survey. For executives, the tests should be applied to each top-level executive individually regardless of the individuals' assignment to a pay grade.

e. If more than one survey is required to consider the relevant factors, the determination of reasonableness should be influenced by their relative significance in the circumstance. If determined reliable and applicable, use the contractor's market comparison studies (see 5-808.3(e)) wherein the contractor has selected jobs to be benchmarked and has compared them with survey job pay rates.

f. As a guide, tests should be applied to jobs that represent at least 40 percent of the benchmarked jobs of a pay structure. Pay grades selected for the comparison tests should contain at least two jobs.

6-413.4 Determination of Reasonableness

a. Wages or salaries of jobs within a pay grade or the equivalent are considered unreasonable if the contractor's total benchmarked job rates significantly exceed the survey data weighted average rates and are not justified. Significance is judgmentally defined as that which exceeds 10 percent. This judgment factor considers that a determination of unreasonable compensation results from material compensation system deficiencies or unjustified pay policies.

b. An example of a test comparison by pay grade is shown in Figure 6-4-1. The following explanation for computing total cost avoidance applies within a pay grade for specific benchmarked jobs. When the sum of the products of the number of employees (by job) multiplied by their average base salaries/wages exceeds the sum of the products of the number of employees (by job) multiplied by the survey weighted average salaries/wages, increased by 10 percent, compute a ratio of this difference to the total salaries/wages of benchmarked jobs. Then apply this ratio to the total grade base salaries/wages to arrive at total base salaries/wages cost avoidance before application of the related fringe benefits rate. Related fringe benefits are costs that vary directly with payroll and include items such as FICA, pension costs, and certain insurance costs.

c. A contractor's pay structure may include jobs in pay grades that cannot be compared to market survey data because

of a low number of incumbents or the jobs are unique to the organization (see 5-808.1). Nonbenchmark jobs within the same pay grade, range, or level as the benchmarked jobs are to be considered unreasonable to the same degree as the benchmarked jobs because they are of relative value based on the contractor's job evaluation system (see 5-808.2(e)).

d. Each individual executive's elements of compensation (such as salaries, cash bonuses, and deferred compensation) may each be subject to the FAR tests and be considered unreasonable if they significantly exceed the market survey weighted average data by 10 percent without justification. Unreasonable costs are computed by applying the percent difference between the amount that the executive compensation element significantly exceeds the survey data to the element amount. However, offsets between allowable elements of compensation should be considered. See 6-413.6 for guidance.

Figure 6-4-1

Figure 6-4-1
Example of Determining Unreasonable Wages at the Grade Level

GRADE 4	(1)	(2)	(3)	(4)	(5)	(6)
JOB TITLE NO.	NO. OF EMPLOYEES	TOTAL SALARY	AVERAGE BASE SALARY	TOTAL SALARIES OF BENCHMARKED JOBS	SURVEY WEIGHTED AVERAGE SALARIES	EXTEND SURVEY AVERAGE (1 × 5)
0023	4	\$108,000	\$27,000	NOT BENCHMARKED		
0026	20	550,500	27,525	\$550,500	\$21,000	\$420,000
0045	5	140,000	28,000	NOT BENCHMARKED		
0049	3	87,000	29,000	NOT BENCHMARKED		
0056	6	169,200	28,200	169,200	28,000	168,000
0077	7	200,200	28,600	200,200	29,750	208,250
0084	3	81,600	27,200	NOT BENCHMARKED		
0087	4	108,000	27,000	NOT BENCHMARKED		
0104	4	114,000	28,500	NOT BENCHMARKED		
0123	15	420,000	28,000	420,000	22,000	330,000
TOTAL	71	\$1,978,500		\$1,339,900		\$1,126,250
EXTENDED SURVEY AVERAGES				\$1,126,250		
LEVEL OF SIGNIFICANCE				1.10	MULTIPLY	
SURVEY LEVEL OF SIGNIFICANCE				\$1,238,875		
TOTAL SALARIES OF BENCHMARKED JOBS				1,339,900	SUBTRACT	
AMOUNT EXCEEDING LEVEL OF SIGNIFICANCE				101,025		
TOTAL SALARIES OF BENCHMARKED JOBS				\$1,339,900	DIVIDE	
RATIO				.0754		
GRADE 4 TOTAL BASE SALARY DOLLARS (COLUMN 2)				\$1,978,500	MULTIPLY	
TOTAL BASE SALARY COST AVOIDANCE				\$ 149,179		
APPLICABLE BENEFIT RATES - 15%				1.15	MULTIPLY	
TOTAL COST AVOIDANCE				\$ 171,556		

In the example above, the contractor benchmarked 4 of the 10 jobs within grade 4. This would be an acceptable amount to determine the overall reasonableness of grade 4. As a guide, at least 40 percent of the benchmarked jobs or total annual pay value of the grade would be sufficient to form a basis on the overall reasonableness of a grade. However, it should be noted that in some instances acceptance could be at a percentage less than 40 percent. Reasons for an acceptance level below 40 percent may include: the contractor is unable to benchmark the jobs within the grade to external surveys or the contractor's policies dictate a lower amount as sufficient enough to form an opinion on the external market comparability of the grade.

6-413.5 Justification

a. Although the contractor's compensation is determined to be unreasonable, as described above, the contractor may provide justification for the excessive compensation. Examples of this are compliance with federal or state laws, employee relation concerns, or labor shortages. However, the contractor should provide sufficient documentation to establish a sound basis for any exceptions.

b. The contractor's justification should address the following considerations for reasonableness as provided in FAR 31.201-3 as follows:

(1) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

(2) The cost is generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance.

(3) Consideration should be given to generally accepted sound business practices, arm's length bargaining, and federal and state laws and regulations.

(4) Consideration should be given to the contractor's responsibilities to the government, other customers, the owners of the business, employees, and the public at large.

(5) Any significant deviations from the contractor's established practices should be considered in determining the reasonableness of a cost.

6-413.6 Offsets

a. For purposes of determining overall reasonableness of compensation, offsets may be presented between otherwise allowable employee compensation elements such as wages, bonuses, pension and savings plan benefits, health insurance benefits, deferred compensation, life insurance benefits, and compensated personal absence benefits per FAR 31.205-6(b)(1)(i). By using offsets, contractors may challenge the determination that an element is unreasonable.

b. An offset element must be an otherwise allowable element of compensation and be quantifiable for comparison with the compensation elements deemed unreasonable. For example, deferred compensation introduced as an offset, must be based upon allowable deferred compensation items. Most stock options, SARs, and phantom stock plans cannot be introduced as an offset because they produce costs which would be unallowable for Government contracts. The offset items must be evaluated in accordance with the same FAR 31.205-6(b)(1) criteria used to evaluate the elements found to be unreasonable in amount; i.e., the offset compensation element must be shown to be from a similar industry, a similar sized firm, the same geographical area, etc.

c. Offsets are computed as to the amount that one element of compensation significantly exceeds the survey weighted average by 10 percent to the amount that the offsetting element falls

under 10 percent of the survey weighted average. For example, an executive's unreasonable salary which exceeded the survey weighted average by 15 percent could be offset by a bonus that only exceeded the survey weighted average by 5 percent.

6-413.7 Fringe Benefits

FAR 31.205-6(m) states that fringe benefits are allowable to the extent that they are reasonable and required by law, employer-employee agreement, or an established contractor policy. Review the contractor's compliance with the FAR criteria as outlined below and make a determination of reasonableness similar to that described for compensation costs. (See 6-413.3(a)) Benefits are considered reasonable to the extent that the total benefit package rate calculated as a percentage of payroll does not significantly exceed the average rate of the comparison data by more than 10 percent. If the total benefit package rate is determined unreasonable, only then conduct an analysis of each of the individual elements comprising the total benefits package.

a. Legally Required. Those benefits that are required by statutory law are workers' compensation, social security, and unemployment compensation. The cost of these benefits are dependent upon the level of wages and salaries.

b. Pensions, Life and Health Insurance. A review of a contractor's insurance and pension programs is normally performed as a Contractor Insurance/Pension Review (CIPR) as set forth in DFARS 242.73 (see 5.1303). The results of these reviews should be considered in the scope of the benefits program review. Refer to 4-1000 for guidance for relying upon the work of others.

c. Pay for Time Not Worked. Benefits within this category include paid vacations and payments in lieu of vacation, payments for holidays and for holidays worked, paid sick leave, and payments for National Guard, Army, other reserve duty, or jury duty. Policies necessary for the control of these benefits include (1) eligibility rules, (2) the size of the benefit, such as how many holidays will the company pay for or how much vacation an employee is entitled to receive, (3) the

effect of holidays or sickness which occurs during a vacation, (4) the degree vacation and unused sick leave time can be banked and carried over to another pay period or paid at time of termination, and (5) circumstances for extra pay rather than paid time off.

d. Other. Other benefits include severance pay, thrift savings plans, deferred compensation plans, stock bonus plans, and employee stock ownership plans (ESOPs). The contractor's policies and procedures for these benefits should be documented, include authorization procedures, requirements for monitoring and reporting the results to management, and control ranges on amounts of benefits to be provided.

e. Allowability of Costs. The cost principles provide specific restrictions on the allowability of some of these benefits as follows:

(1) Severance Pay - FAR 31.205-6(g), refer to 7-1907 for guidance on the evaluation of these costs.

(2) ESOP - FAR 31-205-6(j)(7), refer to 7-1914 for guidance on the evaluation of these costs.

6-414 Reasonableness of Compensation Costs of Owners, Executives, and Other Employees Which Poses a Higher Risk of Unreasonable Compensation

6-414.1 Introduction

a. FAR 31.205-6(b)(2) provides for special consideration of compensation paid or proposed for employees under certain circumstances. Principally, the special circumstances pertain to employees who are also owners, partners, or persons committed to acquire a substantial financial interest in the company. The special circumstances also include employees who are family members of such persons. In general, the special circumstances criteria include those employees who can exercise influence over their own compensation, either directly or through the authority of a family member. The ability to influence their own compensation creates a higher risk that such employees could pay themselves unreasonable compensation.

b. Because of their ownership or family position, such persons are often company executives. In many cases, employees who are executives or members of a corporate board of directors, but who are not owners, have been delegated ownership type authority to act without being subject to significant oversight. Such non-owner employees should also be considered as higher risks for unreasonable compensation. Such persons would normally include officers of the company.

6-414.2 Compensation System Review (CSR) Considerations

a. CSRs are performed to evaluate the systems utilized by the contractor to set compensation for its employees. To the extent that the systems are well designed and properly operated, the audit of compensation costs can rely to a greater degree upon the costs generated by the system. Well designed compensation systems must have internal controls included in its design which will ensure that its provisions are carried out.

b. Within organizations, there are usually employees whose decisions are not reviewed or controlled due to their positions within the organization. A CSR type audit of costs should not accept the compensation of such individuals based upon system design since there can be no assurance that the design has been or will be adhered to other than actual testing of the costs for reasonableness. Audits of compensation of employees falling into the higher risk categories should include sufficient testing to determine if the compensation of each such employee is reasonable for the period covered by the audit.

6-414.3 Ownership and Substantial Financial Interest

If an employee owns less than 100 percent of a company, the employee may still exercise influence over the decision making process. All partners in a partnership arrangement by definition have substantial influence. Many authorities (e.g., the SEC) quantify the ownership necessary to influence a corporation's decisions as 10 percent of the voting stock. The auditor should consider all sole owners, partners, and persons meeting the 10

percent standard to have influence over their own compensation. The auditor should also consider the combination of corporate voting power held by one family in determining if those family members who are employees can influence their own compensation.

6-414.4 Review for Unreasonable Compensation

a. In general, the review procedures in 6-413 apply to such individuals. However, the reason such employees are considered high risk is that they are not subject to the contractor's normal internal controls over compensation. Therefore, the auditor may not rely on those normal internal controls.

b. Such higher risk employees may nominally be part of a class of employees. (The president's son may be an engineer in the design department or an owner of 25 percent of the firm may be one of several scientists working in research.) The auditor should not accept their compensation as reasonable because the class is reasonable as a whole without checking to assure that the higher risk employees have substantially equal duties and compensation as the other members of the class. Especially in the case of family members of owners or executives, such an employee may be overgraded considering the duties actually performed or simply paid more than others doing the same work.

c. Executive positions within a company are usually unique positions within that company. Only the largest of firms have the potential for a class of employees performing vice-presidential level duties which can be described as having similar rank, function, and responsibility. In the normal circumstance, executives are not part of a class of employees and must be evaluated individually.

d. Such positions are best evaluated by comparison to positions with comparable rank, function, and responsibility in other firms of similar size. If the firm changes in size, prior determinations of reasonable compensation amounts will need to be reevaluated.

e. Reasonable executive compensation should also maintain internal equity with compensation paid to non-executive em-

ployees. If the non-executive are being paid average compensation, apparent breaches of internal equity are a warning that the executive compensation may be unreasonable.

f. Determination should be made that compensation is reasonable for the personal services rendered. Owners may claim excessive amounts as costs. Such amounts in excess of the reasonable amount for personal services rendered are actually a distribution of profits. However, payments made to owners are not automatically unallowable if the payments are a distribution of profits on the accounting records of the enterprise. Some smaller firms, including sole owners and partnerships, regularly compensate owners through distribution of profits. These amounts should only be questioned if the total compensation paid to an individual exceeds an amount reasonable for the services performed.

g. For closely held corporations, compensation, including bonuses, shall not be recognized in amounts exceeding those costs that are deductible as compensation under the Internal Revenue Code (IRC) and regulations under it.

(1) To be deductible under the IRC and regulations, the total compensation paid must meet the test of reasonableness. In general, reasonableness under the Code and regulations is such amount as would be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date of agreement with the employee for the services, not those existing at the date when the amount is questioned.

(2) Excess compensation received by a shareholder is considered by the IRS to be constructive dividends. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

6-414.5 Reporting on Compensation Paid to Higher Risk Employees

a. Compensation system review audits should exclude positions or individual employees not effectively covered by the compensation system's controls from any opinion that the contractor's compensation system is adequate.

b. For incurred costs, opinions on such employees' compensation should be limited to recommendations on the acceptance of specific compensation amounts claimed which are found to be reasonable for the services rendered and disallowance of amounts found to be unreasonable.

c. For forward pricing, the determination of reasonableness is based on an evaluation of projections made by the contractor.

d. When compensation of employees becomes unreasonable due to changed circumstances after some period of time during which the Government considered compensation paid to be reasonable, the contractor is generally afforded a period of time to adjust its compensation levels before the costs are questioned. Compensation of owners and executives is more flexible and is generally dependent on circumstances as they occur. Thus, compensation of owners and executives

may be questioned after a shorter period of time if circumstances used to support the compensation change. Of course, any increased compensation may be questioned immediately if it is unreasonable due to a change in the previously reviewed compensation system or a failure to follow that system.

6-414.6 Termination Payments to Owners and Executives

a. It would be unreasonable for an owner to terminate himself/herself and claim compensation for the termination. Allowable severance payments must be for involuntary terminations. All other termination payments must make economic sense to be allowable. If a payment makes economic sense, then the profit motive should be sufficient reason for the owner to retire. Owners receive their payment through the profit from their decisions.

b. The auditor should also be alert to termination agreements made with retiring owners and executives to pay them for consulting services for some period of time after retirement. The payments should be commensurate with services expected from the retiree. Such payments may represent unallowable compensation payments.

6-500 Section 5 — Audit of Incurred Other Direct Costs and Credits**6-501 Introduction**

This section presents audit guidance for the review and evaluation of other direct costs and credits. In addition to direct labor and material (prime costs), which can be readily identified with a specific job, there are other types of expenses which under certain circumstances may be charged directly to a specific job. These are generally referred to as "other direct costs." Examples are: (1) special tooling, dies, jigs, and fixtures; (2) plant rearrangement; (3) packaging and packing; (4) consultant's fees; (5) outbound freight; (6) expediting; (7) royalties; (8) travel; (9) long distance telephone; (10) scrap sales; and (11) deposit returns. Costs of this nature may be charged direct to jobs, allocated on some representative basis, or charged partially direct and partially by allocation.

6-502 Audit Objectives

a. The objectives in auditing other direct costs are to determine whether (1) the contractor's cost representations are reliable and accurate, (2) the amounts charged to government contracts are reasonable and are allocable to government contracts, (3) costs have been accumulated in accordance with generally accepted accounting principles appropriate in the circumstances, and (4) the contractor has been consistent in allocating such costs to commercial and government work.

b. Of special concern in the other direct cost area is the differentiation between direct and indirect cost. Therefore, the audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner.

6-503 Audit Approach

The auditor should determine whether the audit could be more efficiently performed by expanding transaction testing (maximum control risk) or reviewing the internal control structure. This assess-

ment will be based on auditor judgement considering the factors in 3-104 and documented in the working papers and permanent file, if applicable.

6-503.1 Systems Review

The same procedures as are identified in 5-1000 should be used (1) to gain an understanding of the contractor's internal control structure (5-100), (2) document in the working papers and permanent files, the understanding of the indirect cost system internal control structure (5-106), (3) test the operational effectiveness of the contractor's internal controls (5-108), and (4) assess control risk as a basis to identify factors relevant to the design of substantive tests (5-109). Transaction testing may be required based on the results of a review of the internal control structure. The extent of the testing required should be based on the assessed control risk (5-109) as documented in the permanent file (MAAR 1).

6-503.2 Transaction Testing

When transaction testing is more economical than a review of the internal control structure or when warranted based on the internal control review, judgementally or statistically select transactions for review following the guidance below and in 3-104, 6-603, 6-605 and 6-800.

6-504 Scope of Audit

The review should provide for the accomplishment of MAARs and may include a review and evaluation of the contractor's internal control structure. The scope of the review should be based on the factors discussed in 3-104 and 6-503 above. Special scope considerations are:

6-504.1 Interrelated Reviews

a. Other direct costs are incurred on the basis of management decisions in a manner similar to the incurrence of indirect costs and are subject to the same internal controls. Whenever practicable, apply the scope of audit described in 6-

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603 to other direct costs and perform the audit in conjunction with the audit of indirect costs. For example, the contractor's policies and procedures regarding the segregation of unallowable travel costs should be the same for both direct and indirect travel.

b. Similarly, when an item is purchased, documents such as the purchase requisition, purchase order, receiving report, and inspection report should identify the contract for which the cost was incurred. When the contractor manufactures components or parts, the work orders and all documents serving as a basis for charges to the work order, such as requisitions and job tickets, should be identified with the contract. Internal controls over accounting, purchasing, subcontracting or make/buy decisions may impact the review of other direct cost.

c. The audit should provide assurance that when items ordinarily chargeable as indirect costs are charged to government work as direct costs, the costs of like items applicable to other work of the contractor are treated in the same manner. CAS 402 or MAAR 7 reviews may provide sufficient documentation to reduce scope.

6-504.2 Review of Bid Proposals and Contract Provisions

a. When the contractor's accounting procedures provide for the accumulation of other direct costs, or the cost representations include other direct costs, the auditor should review negotiation memorandums and the contract provisions to ascertain whether it was the intent of the contracting parties to treat certain costs as direct rather than as indirect costs. Contracts awarded on a firm fixed-price basis generally do not contain provisions concerning costs to be charged to the contract. However, if there is information that a category of cost was considered as a direct charge during the negotiation of a firm fixed-price contract, the auditor should determine that other government contracts do not share the same cost through an indirect cost allocation.

b. When auditing costs of special tooling or special equipment, review the terms of the contract to determine whether the costs are to be treated as other

direct costs. If so, evaluate the contractor's controls to determine whether they ensure the appropriate disposition of specialized items upon completion of the contract. When a contract is silent concerning these types of costs, seek the assistance of the contracting officer and ascertain the necessity for the acquisition of the equipment and the propriety of treating the costs as a direct charge to the contract. (See 3-200, 7-1906, and 14-402).

6-504.3 Disclosure Statement

The auditor should be alert to inconsistencies in the treatment of other direct costs which may result in inequitable charges to government contracts. Part 3 of the disclosure statement delineates the contractor's policy regarding differentiation between direct and indirect costs, identifies contractor's other direct costs, and explains deviations from the contractor's normal direct charging policy. Because a primary concern regarding other direct costs relates to consistency of treatment, a review of disclosed practices may indicate areas for review. When such inconsistencies are noted, advise the contracting officer to take corrective action. When the amounts are significant and consistent treatment cannot be attained, it may be necessary to establish special indirect cost rates for the contracts affected to avoid inequitable charges to those contracts.

6-504.4 Selected Areas of Cost

The auditor should review the contractor's presentation for new, unusual, or miscellaneous types of ODC. Guidance on audit methods and techniques for selected areas of costs are provided in 7-000.

6-505 Audit Procedures

The auditor should determine that all items of other direct costs are readily identifiable with the contract to which they have been charged. The audit of other direct costs should include a review and evaluation of:

a. The reasonableness of the amount incurred in relation to the benefits to be derived;

b. The allocability of the cost to the product, service, activity, or contract to which it was charged, and the consistency of application; and

c. The allowability of the cost in accordance with FAR/DFARS and the provisions of the contract.

6-505.1 Reasonableness of Accounting Costs in Relation to Benefits

Apply the guidelines in FAR Part 31 to determine whether other direct costs are reasonable in amount in relation to the contractual benefits to be derived. When the amount is not significant in comparison to the total costs, determine whether the cost of additional time expended by cost clerks, voucher examiners, payroll analysts, and others to accomplish the refinements are commensurate with the benefits the government may expect to derive from maintaining such precise accounting.

6-505.2 Allocation Methods and Consistency of Application

a. Evaluate the contractor's methods for identifying other direct costs and determine whether such methods result in an equitable distribution of costs to both government and other work. When items are charged to a government contract as other direct costs, the contractor's procedures should provide for like or comparable items to be similarly charged to other work. When the contractor has not been consistent, eliminate those comparable or similar cost items applicable to all other work from the indirect expense pool prior to allocation. Make sufficient tests to determine consistency of accounting treatment.

b. Under certain circumstances, it is appropriate to treat certain types of costs as direct charges and as overhead. For example, all travel directly applicable to government contracts or other work may be charged direct, while travel, such as for recruitment and general administration, may be treated as overhead.

c. When a contractor manufactures special tools, review the propriety of allocating overhead to the in-house manufacturing process. When special tools

are manufactured in a separate department which is considered a production department, the indirect costs of the department and any prorations from other service departments constitute tooling overhead allocable to tooling labor costs. However, when the contractor considers the special tooling department as an indirect department, overhead would not be allocable because the overhead generated remains in the expense pool and is subsequently prorated to production. Consider the equity of this method as part of the review of the contractor's procedures for accounting for indirect costs.

6-505.3 Allowability of Costs

Certain categories of cost (FAR Part 31-Appendix A of this manual) are not allowable in pricing government contracts whether charged direct or through allocation. Further, the terms of a contract may specifically preclude the contractor from classifying certain classes of costs as "direct," and conversely, the contract may permit the contractor to reflect certain classes of costs as direct costs. However, in all instances, the allowability of costs under government contracts is subject to the tests of allocability and reasonableness.

6-506 Coordination with Government Technical Personnel

The auditor should request technical assistance to determine the need as well as the reasonableness of the costs in areas outside his or her technical competence and for which the auditor cannot make an independent assessment. For example, technical advice may be required when the contractor manufactures special tools or incurs plant rearrangement costs which are charged to other direct costs, or, when packaging costs represent a significant amount of other direct costs, in which event the auditor should seek the services of government packaging experts to determine the need as well as the reasonableness of the costs for packaging. Guidance on requesting and using the work of technical specialists is in Appendix D.

6-600 Section 6 — Audit of Incurred Indirect Costs

6-601 Introduction

This section presents audit guidance and procedures for the review of indirect costs used in establishing final indirect cost rates for other than firm fixed-price type contracts. Refer to Section 5-1000, Indirect/Other Direct Cost Systems, for guidance and procedures on the evaluation of the contractor's policies, procedures, and internal controls which affect indirect costs. The guidance is also to be used for the determination of allowable indirect costs under other circumstances such as reviews of terminated contracts (12-304.15), reviews of progress payment requests (14-200), and for interim reviews of incurred costs.

a. An indirect cost is any cost which is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or an intermediate cost objective (FAR 31.203 (a)). Indirect costs are to be accumulated by logical groups and distributed on the basis of benefits accruing to the several cost objectives. The numbers and composition of cost groupings should be governed by practical considerations.

b. Procedures for settling final indirect cost rates are presented in 6-700. Guidance for audits of the base costs to which the rates apply is provided in this section.

6-602 Audit Objectives

a. The audit objectives are to evaluate and determine (1) the allowability, allocability, and reasonableness of the costs charged to government contracts; (2) the propriety of the methods used to allocate indirect costs to government contracts; (3) the correctness of the bases used to apportion indirect costs; (4) the appropriateness of the indirect cost period; (5) the consistency of the application of policies and procedures to the government and to other operations; and (6) the mathematical accuracy of the computed final indirect cost rates.

b. The discovery of fraud or other unlawful/improper activity is not the primary audit objective, but the auditor

must be attentive to any condition which suggests that such a situation may exist. If such activity is suspected, the circumstances should be reported in accordance with 4-700.

6-603 Scope of Audit

a. The review should provide for the accomplishment of MAARs (see 6-603.2 below) and should include: (1) a review and evaluation of the contractor's system of internal control, including the means by which all echelons of management control the level of indirect costs (see 5-1000); (2) a review of the composition and suitability of the allocation bases; (3) a review of the composition of the various indirect cost pools to ascertain whether they are logical and bear a reasonable relationship to the bases used for apportioning expenses to operations; (4) a review of selected indirect cost accounts; (5) a verification to the financial records; and (6) a verification of the mathematical accuracy of the rate computation.

b. The extent of audit effort should be influenced by: (1) the adequacy of the contractor's policies, procedures, and internal controls, including the contractor's monitoring and testing efforts (see 5-1000); (2) the mandatory annual audit requirements (MAARs); (3) the types of government contracts and the percentage of participation (the total dollar value of the indirect costs allocated to government contracts); (4) the adequacy of the records based on past experience and the impact of changed conditions; and (5) the contract terms.

6-603.1 Types of Contracts and Government Participation

a. For discussion, contracts other than firm-fixed-price, time-and-materials, or labor-hour are referred to as cost-reimbursable. The various types of contracts are more fully defined in FAR Part 16. Audits of incurred indirect costs are performed only at contractors with cost-reimbursable contracts. The higher the value and percentage of reimbursable

costs, the greater the need to review management decisions and internal controls over costs and the greater the depth of review of selected accounts. The higher the percentage of firm-fixed-price or commercial work, the greater the need to review the allocation of costs between government and other contracts. An analysis of participation may result in reduced scope for the whole audit or only certain pools. For instance, pools with high government participation may require detailed account analysis, whereas pools with no government participation may require only a determination that the allocation base is appropriate to assure absorption of all allocable costs.

b. The scope of audit may also be affected by the percentage and amount of subcontract or interdivisional work performed. Prime contractors have a responsibility to audit their subcontractors. The auditor cognizant of the prime or higher tier contractor is responsible for obtaining adequate audit coverage of subcontracts, either from the prime contractor or from the cognizant government auditor (MAAR 12) (see 6-311.4 for guidance on subcontract coverage by the prime auditor).

c. Contractors may have both DoD and non-DoD contracts which may affect the scope of audit because of differences in procurement regulations. Some non-DoD agencies request and reimburse DCAA for audit services; others do not. The requirement for our services on non-DoD contracts should be confirmed by a review of the contract terms or discussion with the appropriate contracting officer or Office of the Inspector General (see 1-300 and 15-100 for guidance on audit services for non-DoD agencies).

6-603.2 Mandatory Annual Audit Requirements (MAARs)

a. MAARs represent basic core audit requirements which should be accomplished along with the other procedures discussed in this section to complete the review of incurred costs. MAARs must be performed at all contractors when warranted by materiality and/or significance. At major contractors it should always be presumed that materiality necessitates accomplishment of all MAARs. At non-

major contractors, auditors are expected to independently make such judgments on the basis of specific circumstances in each audit. General guidance on MAARs is provided in 6-104. Descriptions of the MAARs are provided in 6-1S1.

b. MAARs are historical audit tests and procedures. However, MAAR 6 (floor checks) and part of MAAR 13 (purchases existence and consumption) can only be accomplished during the contractor fiscal year to which they apply. It may be beneficial from a staffing viewpoint to accomplish portions of other MAARs during the year.

c. The extent of audit necessary to accomplish any MAAR is a matter of auditor judgment, subject to supervisory review. Because of the dollar value of cost reimbursable work at major contractor locations, all MAARs will be accomplished for each year. Considerations of materiality, based on government participation and other factors, may result in a decision to perform minimal transaction testing.

6-603.3 Procedures and Internal Controls

The adequacy of the contractor's policies, procedures, and internal controls increases the auditor's reliance on cost representations and reduces the extent of testing and verification which might otherwise be required to express an opinion on the acceptability of indirect costs. Refer to section 5-1000 for guidance on reviewing and evaluating contractor indirect/other direct cost systems and related internal controls. The permanent files should also provide information on the contractor's internal controls and problem areas disclosed during ongoing audits and should be reviewed during determinations of audit scope.

6-603.4 Past Experience and Changed Conditions

a. Past experience can be a significant determinant of scope. Reviews of prior audits not only provide the accounts where costs have been questioned in the past, but also the accounts where costs have been voluntarily deleted. If past experience indicates good internal control over unallowable costs and minimum costs questioned, transaction testing can

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be reduced if the auditor can determine that the controls are still in place. A comparative analysis of cost accounts by year provides an indication of significant changes in cost account activity or changes in methods of allocation.

b. Changed conditions (MAAR 7) affect the reasonableness of costs and the equitable distribution of indirect costs. Changes in conditions may significantly affect the development of indirect cost rates. These changes may include the award of a significant cost-reimbursement contract when prior government contracts were primarily of the firm-fixed-price type; a shift in emphasis from research to production, which may require reclassifying indirect costs into different departments; or changing the method of allocating and distributing indirect costs. Further, significant variations in levels of production and technological modernization of manufacturing facilities (14-800) may require a review to determine the effect on facilities, labor, and indirect costs.

6-603.5 Contract Terms

a. As discussed in 6-603.1(c) above, a mixture of DoD and non-DoD contracts may result in increased scope to accommodate the differences in procurement regulations. The contract briefs state the procurement regulations which are applicable and they may also indicate special contract terms or conditions on cost allowability or allocability which may increase scope. The contract briefs may indicate advance agreements made by the contracting officer affecting allowability or allocability, the most common of which are IR&D/B&P agreements and precontract costs (see FAR 31.109 for a discussion of advance agreements).

b. The auditor must identify the contractor's status with respect to CAS (not covered; subject to 401 and 402 only; fully covered; fully covered and required to file a disclosure statement). Compliance control schedules and FMIS CAS Compliance Testing Reports maintained for each CAS-covered contractor (see 8-305) identify the status of a contractor's compliance with CAS and pinpoint specific areas requiring consideration in establishing the audit scope.

6-603.6 Multi-Year Auditing

a. The auditor should consider multi-year audit techniques when establishing the audit scope. At nonmajor contractors, the auditor may determine it would be efficient to include in the audit scope two or more fiscal years' incurred costs. Also, at major contractors, it may be efficient to audit certain accounts on a multi-year basis.

b. Multi-year auditing techniques should be based on the following guidelines:

(1) For each year being audited, perform the following MAARs: Permanent File MAARs (1, 3, 7); Reconciliation MAARs (2, 4, 9, 14, 15, 19); and Special Purpose MAARs (5, 6, 8, 12, 13, 17, 18). See CAM 6-104.

(2) Perform the transaction testing MAARs 10, 11, 16, and 20 in accordance with the following guidance. Normally, transaction testing will be performed across all years. However, transaction testing can be limited to one year if account balances and conditions are similar for all years and no significant exceptions are identified. If significant exceptions are found, transaction testing should then be expanded across all years. The auditor should document the risk assessment decision to limit transaction testing to one year when no exceptions are found. When account balances vary significantly or conditions have changed from year to year, transaction testing must be performed across all years.

(3) Transaction tests of any new accounts should be performed in the year they first appear, if the accounts are material.

c. Some of the potential advantages of multi-year auditing include increased efficiency in transaction testing and the use of one set of working papers to audit more than one year's costs. Also, one audit report may be used to cover the years audited.

6-604 Review and Evaluation of Contractor's Policies, Procedures, and Internal Controls

a. Chapter 5-100 presents general guidance for the review and evaluation of a

contractor's policies, procedures, and internal controls. Guidelines applicable to the review and evaluation of policies, procedures, and internal controls as they relate to indirect/other direct costs are discussed in 5-1000.

b. Sources for the review of internal controls are found in the permanent files (see 4-405.1). The Internal Control Audit Planning Summary, Disclosure Statements, and CAS Compliance Control Schedules should be reviewed and updated during incurred cost audits. Inadequate internal controls or noncompliances with FAR or CAS should be annotated on the appropriate control document, e.g., Internal Control Audit Planning Summary or CAS compliance control schedules (MAAR 1), and reported immediately to the ACO.

6-604.1 Effect of Changed Conditions

The auditor should review for changes in procedures and practices for charging direct or indirect costs. Such changes could result in circumventing cost targets or ceilings or produce inconsistencies in the treatment of direct and indirect costs, especially between cost reimbursable and other contracts or between government and other contracts. The review for changes in direct and indirect charging satisfies MAAR 7.

a. Determining Changed Conditions. A review of corporate minutes, which generally record top management decisions, may disclose changes having an impact on indirect cost. Discussions with contractor personnel and physical plant observations (see 6-608.2a) also provide information on changed conditions. Today, physical plant observations take on a new importance in view of contractors' current trend toward modernization of manufacturing facilities (5-108d, 14-800). In addition, comparisons of the current claim with prior year amounts (see 6-608.2c) and a review of the permanent files may disclose changes.

b. Reporting Changed Conditions. As a continuing audit responsibility, the auditor should test the internal controls and procedures for reporting changed conditions which affect indirect costs. When a change in indirect cost method is proposed by a contractor, the effect (in

dollars) on existing contracts should be studied and presented by the contractor as a part of its overall support for the change. The contractor should have a procedure requiring this support and identifying any required reporting. For CAS-covered contractors, the reporting requirements for accounting changes are in 8-303.3 and FAR 52.230-5(a). There is no similar requirement for non-CAS-covered contractors; however, a similar analysis will assist the auditor in evaluating the proposed change. Every effort should be made to obtain this information from the contractor; otherwise, the auditor should estimate the impact.

c. Review of Changes. When changes are identified, they should be reviewed to determine that (1) they comply with CAS (see 8-303.3), if applicable, and (2) they do not have the effect of improperly circumventing cost targets or ceilings of certain contracts or other significant cost categories.

6-604.2 Voluntary Management Reductions

Contractors with weak or ineffective controls to separately identify and exclude unallowable costs frequently attempt to reduce their risk of noncompliance by using alternative procedures. The most common procedure is the application of bottom line reductions to estimate the amount of unallowable costs. These reductions, generally referred to as voluntary management reductions, are often unsupported estimates and do not identify specific unallowable costs. The use of this type of reduction is not an acceptable alternative to an effective system of controls. Cost Accounting Standard 405 and FAR 31.201-6 (accounting for unallowable costs) require contractors to specifically identify and exclude unallowable costs from incurred cost proposals submitted to the government. The auditor should not offset any unallowable costs found during the audit with voluntary management reductions. Since the auditor does not review all transactions, the probability exists when contractors have ineffective controls that the actual amount of unallowable costs may exceed the management reduction. The auditor should also prepare appropriate

CAS/FAR noncompliance and internal control deficiency reports when the contractor uses management reductions in lieu of having adequate controls to identify and segregate unallowable costs.

6-605 Indirect Cost Base Period

a. The contractor must select a time period to be used as a base period (cost accounting period) for accumulating and reporting costs. The base period for the allocation of indirect expenses to operations is generally the period during which the expenses were incurred (matching principle) and usually represents a calendar year or a fiscal year.

(1) For contracts subject to modified CAS coverage and for non-CAS-covered contracts, the base period for allocating indirect costs must be determined in accordance with FAR 31.203(e). The base period will normally be the contractor's fiscal year.

(2) For contracts subject to full CAS coverage, the criteria and guidance in CAS 406 (8-406) must be used for selecting the cost accounting periods used in allocating indirect costs (FAR 31.203(e)). Instances of noncompliance with CAS 406 should be reported to the ACO immediately (see 8-300 for guidance on reporting noncompliances).

b. In certain circumstances, it may be more equitable for contract costing purposes to use a shorter indirect cost base period than the contractor's normal fiscal year. These circumstances may include the contract performance within a shorter period of time, or the provision of items or services for the government which are different from the normal type of activities. Other occurrences which may influence the cost accounting period include a major change in the contractor's organization, or the phaseout or assumption of a program or area of activity having an unusual effect on indirect costs. When an indirect cost base period other than the fiscal year is used, the auditor should determine that the base period is sufficiently long to avoid inaccuracies resulting from seasonal fluctuations, or that appropriate adjustments have been made; that a proportionate share of end of period adjustments, deferrals, and ac-

cruals is included; and that CAS 406 criteria are met, if applicable.

c. Quick closeout procedures which allow the final period of a contract to be closed at other than final rates for the full year are discussed in 6-610.2 and 6-1009.

6-606 Evaluation of Allocation Methods

6-606.1 General

a. Indirect costs should be accumulated by logical (homogeneous) cost groupings (pools), with due consideration of the reasons for incurring such costs, and allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pool costs to the final cost objective (FAR 31.203(b)). To satisfy MAAR No. 18, the auditor should determine that the allocation bases used by the contractor for the allocation of indirect costs are equitable and consistent with any applicable CAS requirements, generally accepted accounting principles, and applicable provisions of the contract. Guidance on the verification of the activity base is in 6-609. Guidance on verification of the rate computation is in 6-610. Guidance on the transitional method for G&A expense under CAS 410 is provided in 8-410a.

b. Knowledge obtained from a review of the internal control structure (see 5-1005) may reduce the extent of audit effort. If not reviewed, the auditor must make a thorough study of the indirect cost activity, including the activity bases used for allocation and the costs to be allocated, to determine whether the activity base chosen by the contractor is appropriate for cost allocation and results in a reasonable measure of the activity. The base should (1) be a reasonable measure of the activity, (2) be measurable without undue expense, and, except for residual G&A expense, (3) fluctuate concurrently with the activity which is the source of the cost.

c. When the methods of allocation have been tested over an extended period and determined to be satisfactory, the auditor presumes that these procedures and methods are still satisfactory. However, when the nature of a business changes

substantially because of a change in volume of commercial or government business, or because of technological modernization of the manufacturing facilities (14-800), the existing methods of allocating indirect costs may not be appropriate and the auditor must review and evaluate them in accordance with existing conditions. If the contractor's method appears to be sound and produces equitable and objective results, it should be accepted as provided for in FAR 31.203 or applicable CAS (403, 410, 418.50(c)). Conversely, a more appropriate basis for allocation purposes should be used when it is determined that the contractor's method produces inequitable results and the amounts involved are significant. Such a condition would result in a FAR 31.203(b) or applicable CAS noncompliance (see 8-300).

d. Part IV of the contractor's disclosure statement provides information on the contractor's bases and pools, including a functional or departmental breakdown of indirect expenses. A review of the disclosure statement (or equivalent data from non-CAS-covered contractors) will frequently assist in determining whether cost allocations are equitable. Any differences or inadequacies should be identified and reported to the ACO in accordance with 8-200. If the contractor is not required to disclose its practices, a comparison should be made between the claim and the contractor's written policies or procedures.

6-606.2 Number and Composition of Pools

a. The number and composition of pools should be governed by practical considerations (FAR 31.203(b)) and/or CAS (418, 403, and 410).

(1) Proper allocation of manufacturing overhead generally requires the use of departmental or burden center rates. However, the use of a single plant-wide rate may be acceptable when it can be demonstrated that its use will result in equitable allocations: for example, when a single product is manufactured; when several products are manufactured but each requires proportionately the same amount of overhead work; or when the contract activity is so small that costs of

such segregation outweigh the benefits received.

(2) When the contractor's accounting system does not provide for the segregation of engineering expenses from the total manufacturing pool, and when engineering costs represent significant costs to the government, the auditor should make appropriate tests to determine the equity of the combined allocation. If the combined allocation is not equitable, the auditor should determine separate rates. For example, engineering effort may not be required on commercial or government contracts, or it may not apply to contracts in the same ratio as manufacturing labor.

(3) Contractors modifying their accounting systems to an advanced cost management system are adopting well thought out plans for distributing and identifying costs to objectives. The shift to an increasing number of cost pools is not for the purpose of fragmenting the existing pools and bases but to portray more accurate product cost. During the accounting system development phase, contractors should consider the cost benefit relationship between a large number of cost pools and better costing in striking a reasonable balance. Auditors should consider and, if necessary, discuss the cost benefit analyses at progress briefings conducted during the implementation period.

b. When a contractor's activities are decentralized, the use of separate indirect cost rates for each geographic location will normally produce more equitable allocations of indirect cost than the use of composite or company-wide rates. Overhead rates determined for off-site activities should be based on eliminating from the overhead pool those types of indirect costs which do not benefit off-site activities. For example, occupancy costs may be eliminated from off-site pools because the contractor uses government facilities.

c. The manner in which contract prices were negotiated may have a significant bearing on the method for absorbing costs on individual contracts or groups of contracts. Advance understandings or "ground rules" may be established by agreement between the contracting officer and the contractor to facilitate final

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cost determination. (See FAR 31.109 for a description of advance agreements.)

d. The cost of money (CAS 414) is an imputed cost which is identified with the total facilities capital associated with each indirect cost pool and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool. The cost of money may be considered to be an indirect expense associated with an individual cost pool but should be separately identified. The cost of money is subject to all of the same allocation procedures as any other indirect expense (see 8-414).

6-606.3 Allocation Bases For Overhead and Service Centers

a. Overhead ordinarily includes costs incurred to support direct labor or acquisition, storage, and issuance of direct materials. Therefore, overhead is ordinarily allocated to final cost objectives without any intermediate allocations. Service centers are departments or other functional units which perform specific technical and/or administrative services for the benefit of other units. Their cost can be allocated partially to specific final cost objectives as direct costs and partially to other indirect cost pools, usually based on units of output.

(1) When CAS is applicable, the auditor should refer to the requirements of CAS 418 and implementing audit guidance in 8-418 in addition to this section. Even though CAS does not apply, the auditor will find the guidance in CAS 418 to be useful in evaluation of allocation bases; however, FAR, not CAS, must be cited as a reason for questioning the appropriateness of the base.

(2) In the evaluation of an allocation base for overhead or service center costs, the auditor should refer to the guidance in CAS 418.50e for pools which do not contain material amounts of the costs of management or supervision of the base activities and CAS 418.50d for those which do. CAS 418.50e recommends a hierarchy of bases, the most preferred being measures of resource consumption followed by measures of output and finally by a surrogate measure which varies in proportion to services received. Since neither consumption nor output of man-

gerial and supervisory effort can be measured in terms of the relative benefit conferred on differing elements of the activity base, CAS 410.50d merely requires that the base be representative of the activity being managed or supervised. CAS 418.50d(2)(i) requires that direct labor hours or direct labor dollars be used for overhead allocation except under special circumstances as noted below, and that selection between the two should be based on which is the more likely to vary in proportion to the costs included in the pool.

b. Acceptable activity bases for apportionment of overhead and service department costs include among others, direct labor hours, direct labor costs, direct labor plus fringe benefits, prime costs, direct material cost, value or units of production, floor space, cubic content, meter readings, and machine hours. Any one or a combination of these may be acceptable in a particular case and unacceptable in another. The following paragraphs contain guidance to assist the auditor in reviewing the more common methods of allocating overhead and service center costs.

(1) Direct Labor Hours. Direct labor hours is an acceptable base for allocation of overhead costs when the employees are largely interchangeable such as in a manufacturing operation. The basic data for using direct labor hours usually are available through job tickets. However, if the cost of accumulating the data is prohibitive, the use of this basis is not recommended.

(2) Direct Labor Cost. This activity base is used for allocating overhead because data are readily available and the method is simple and economical. Labor costs are usually controlled by payroll records and the general books of account, and the base is subject to audit verification. This basis is usually acceptable at a manufacturing location when labor rates are relatively uniform and when production labor is a significant element of the product cost.

(a) This basis is often used at non-manufacturing locations. Employees at such locations have widely differing skills and salaries which are correlated to their technical expertise, which in turn is the

subject matter of contracts with such locations. Related overhead is primarily supervision and occupancy, both of which tend to vary directly with the cost of professional labor.

(b) When direct labor cost is the basis for allocating costs, the auditor should normally eliminate all overtime and shift premium costs from the base. However, overtime and shift premium costs need not be excluded from the base when (1) the amount of audit work required does not warrant it or (2) equally equitable results will be obtained even though these additional costs are included.

(c) When direct engineering labor cost is the base for allocating the related engineering costs at a manufacturing location, adequate tests should be made of the salary or wage levels of employees engaged on government contracts compared to the overall engineering salary and wage structure. If the average wage of employees engaged on government contracts is substantially different from the overall average, the direct labor cost method ordinarily will not be acceptable. In such instances, the auditor should consider recommending a direct engineering labor hour base.

(3) Direct Material Cost. Direct material cost may be used to allocate costs of material handling (purchasing, receiving, or shipping) departments. It is particularly important that the auditor analyze the pool and base relationship. For example, total material cost may not be an appropriate base if it includes significant costs for items which are not received at the contractor's plant but are drop shipped directly to the end user.

(4) Unit of Product. The unit of product method is perhaps the simplest form of allocation because it distributes overhead equally to each unit of product manufactured during the period. However, the use of this method is limited to companies producing a single product, or a few products which contain elements such as weight, dimension, or other measure common to all the products produced.

(5) Floor Space, Cubic Content, and Meter Readings. Floor space area, value of space, cubic content, or meter readings may be used to allocate certain types of

indirect costs on a plant-wide basis. One or more of these bases may be used to allocate service department expenses to producing departments or to cost centers.

(6) Machine Hours. The use of machine hours as the basis for allocating indirect costs may be appropriate when the principal factor in production is the use of machinery. It is most frequently used to allocate the indirect costs of a manufacturing department or service center using large machines. Today's trend toward technological modernization of manufacturing facilities tends to intensify machine orientation on the factory floor (14-800). As a result, careful consideration must be given to the suitability of overhead allocation bases. With the movement toward a machine orientation, the use of machine hours and other machine oriented bases (such as process time and operation movements) is likely to become relatively more appropriate. Objections to the use of machine hours as a basis for allocating overhead costs include the expense of accumulating special cost data not otherwise required. However, with the advent of machinery encompassing the ability to accumulate performance data, these objections may not continue to be applicable.

c. Some advanced cost management systems will place a stronger focus on the activities of a business. For businesses that made technological progress, this means a shift to more machine oriented allocation bases, such as machine hours, process time, and operational movements. In other areas of the business operations, appropriate allocation bases may be transaction volume or services rendered, such as space utilization, plant layout, engineering change notices, and purchase requisitions. Selection of appropriate allocation bases which have a causal or beneficial relationship with the pooled costs is no different for an ACMS (see 14-800) than for traditional accounting and is compatible with the requirements of CAS 418.50(e).

6-606.4 Allocation Bases for General and Administrative Expense Other Than Corporate/Home Office Expense

a. G&A expenses are any management, financial, and other expenses which are

incurred by or allocated to a business unit and which are for the general management and administration of the business unit as a whole. When CAS 410 applies, the auditor should refer to the requirements of the standard and implementing audit guidance in 8-410. When CAS 410 does not apply, the auditor may refer to CAS 410 in conjunction with the guidance in this section. Audits of corporate/home office expense allocations, and G&A expense allocation under facilities contracts are discussed in 6-606.5 and 6-606.6.

(1) The pool grouping should be assessed using the principles set forth in FAR 31.201-4, Allocability, and 31.203, Indirect Costs. The expenses in the G&A pool should represent only the cost of those activities that are necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown. The cost of those activities incurred specifically for a contract or that can be distributed to both government and other work in reasonable proportion to the benefits received should be removed from the G&A pool and distributed to the final cost objectives on a more appropriate basis. Expenses which are not G&A expenses but are insignificant in amount may be included in the G&A expense pool.

(2) The distribution base should be evaluated to assure that it is common to all cost objectives to which the G&A pool is to be allocated. As stated in CAS 410.50(b)(1), the G&A allocation base should be a cost input base representing the total activity of the business unit. Cost input bases are discussed in 6-606.4b(1) and include total cost input, value added and single element. CAS also permits special allocations under certain conditions (CAS 410.50(j)) and permits variants of the foregoing cost input bases if they are representative of the total year's business activity and produce an equitable distribution of the G&A expenses to all final cost objectives (CAS 410 supplement). The auditor must recommend another distribution base when it is determined that the selected base does not adequately represent the total year's business activity or results in an

inequitable distribution of the G&A expenses to final cost objectives.

(3) All contractors are covered by FAR 31.203(b), which states, "Indirect costs shall be accumulated by logical groupings (which) should be determined so as to permit distribution of the groupings on the basis of the benefits accruing to the various cost objectives." If a contractor which is not CAS-covered has a single pool, the auditor must evaluate its allocation base against this requirement.

b. The subparagraphs below provide comments on distribution bases which may be proposed for allocating G&A expense to contracts/jobs where Cost Accounting Standards do not apply. In the event any of these bases of allocation are used and accepted on the basis that no inequity results, such acceptance should be qualified in the audit report and the contractor notified that a more appropriate distribution base will be used in the future if it is determined that the selected base is creating an inequity.

(1) Cost Input. Cost input is the cost, except G&A, which for contract cost purposes is allocable to the production of goods and services during the cost accounting period. The most often used bases are: total cost input (TCI), all costs excluding G&A; value-added cost input, all costs excluding material, subcontracts, and G&A; and single element cost input. Cost input bases are generally acceptable for government contracts because they express the causal and beneficial relationship between G&A expenses and all of the final cost objectives of a cost accounting period (matching principle).

(2) Cost of Goods Sold. The cost of goods sold base is often identical to TCI, and when identical it is acceptable. Its advantage is that the amount is generally available from the accounting records and does not require separate computation. Cost of goods sold bases may be unsatisfactory when the G&A expense allowable under government contracts is more closely related to production for the period than to products distributed and sold. Distortions are most likely to result when some of the contractor's products require a long manufacturing cycle, or when commercial items are produced for stock or leasing rather than to fill sales

commitments. G&A expenses which are not clearly a part of production may not be applied to inventory because to do so would violate generally accepted accounting principles. Distortion may also result if a contractor classifies all costs incurred under cost-type contracts as sales when the costs are incurred, but does not record sales under fixed-price contracts and other work until shipment of the completed product.

(3) Cost of Sales. Cost of sales includes selling costs whereas cost of goods sold does not. The cost of sales base is inequitable because the contractor is precluded from recovering allowable selling costs and must allocate G&A to all selling costs. All other considerations affecting cost of goods sold apply to cost of sales.

(4) Cost of Goods Manufactured. Cost of goods manufactured differs from cost of goods sold in that it includes ending inventories and excludes beginning inventories. Cost of goods manufactured is generally not an acceptable allocation base for G&A expense under government contracts because it does not adequately represent the cost of production for the accounting period. Cost of goods manufactured includes prior period costs applicable to goods in process at the beginning of the accounting period and excludes current period costs applicable to goods remaining in process at the end of the accounting period. Distortions are most likely to result when the contractor's products require varying manufacturing cycles, some longer than others, or inventories of raw materials and work in process vary significantly between the beginning and end of the accounting periods.

(5) Total Sales. Total sales as a basis for allocating G&A expense is generally not acceptable for government contracts because: (1) the concurrence of sales with production usually varies between the items produced for the government and those produced commercially, (2) the margin of profit may vary appreciably among contracts and between government and other work, and (3) the final selling price of incentive type contracts or other contracts which contain price revision terms is not known until the work

has been completed and the price negotiated.

6-606.5 Allocation Bases for Corporate/Home Office Expense

a. When CAS 403 applies, reference should be made to the requirements of the standard and implementing audit guidance in 8-403. When CAS 403 does not apply, it may be used as general information in conjunction with the guidance in this section.

b. Home office expense is the cost of administering the overall operations of a multi-plant or multi-segment company. Home offices typically establish policy for and provide guidance to the segments in their operations. They usually perform management, supervisory, or administrative functions, but may also perform service functions in support of the operations of the various segments. The costs may include: (1) those incurred for the benefit of a specific segment, such as specialized consulting services or leases for specific facilities; (2) those incurred for the benefit of several but not all segments, or for several segments in differing proportions, such as a central computer center or similar service operations or fringe benefit costs such as pensions and insurance; (3) those incurred for the common benefit of all segments, such as board of directors expenses or top executive salaries. Costs of the third type, often referred to as "residual" corporate/home office expense, are typically allocated to all segments over a common allocation base except as discussed in d. below. Costs of the first two types, where significant, require separate allocation for equitable costing of government contracts at the various segments.

c. The segment auditor should identify all type (1) and type (2) expenditures allocated or charged to the segment, and should request audit assistance simultaneously with the request for verification of the corporate (type (3)) allocation. Whether or not assist audit requests have been received, the corporate auditor should initiate the reviews of charged and allocated expense without delay. The corporate auditor is also required to review and report on significant matters

contained in the corporate financial statements, minutes, SEC filings, and tax returns, and to furnish an information copy of the published financial statements to the segment auditors.

d. To evaluate the bases used by the contractor to distribute home office expenses, the auditor should carefully review the organizational structure and operations of the corporate office and each corporate segment, including details of the type of service and support rendered by the corporate office to each segment. This may require close cooperation among the contract auditors cognizant of the company sites. (See 15-200 for information on the contract audit coordinator (CAC) program which has been established to facilitate this coordination within DCAA.) In addition, the corporate/home office auditor is responsible for the necessary reviews of segments not involved in government contract work. The objective is to see that the contractor's allocations proportionately distribute home office costs to all segments of the business on the basis of the relative benefits received. Use the applicable contract cost principles (such as FAR 31.201-4, 31.202, and 31.203) as criteria to evaluate the contractor's method.

e. Residual expenses generally have no discernible direct benefit to a particular segment but are necessary to the overall business operations. They may be categorized as costs relating to the prudent management of all resources at the disposal of the corporation. Residual expenses may include the salaries, fringe benefits, occupancy costs, taxes, and other administrative expenses of the board of directors, executive committees, corporate officers, and administrative/executive management officials. The basis of allocation of residual expenses should reflect the total activities of all segments of the business. However, certain segments may require special allocations of residual expense if their operations are relatively self-contained or self-sufficient and/or require minimal administrative support from the corporate/home office. Conversely, a segment may require special allocation in amounts greater than the average rate if it is highly dependent upon the home office

staff for general administrative support. (See 6-606.6 regarding allocations to GOCO activities.)

f. The form of the business (foreign or domestic), the extent of ownership (wholly- or partially-owned), or the accounting treatment for financial accounting purposes (consolidated or unconsolidated) are not basic criteria for determining whether a particular segment should be included in or excluded from the residual allocation base. Also, the fact that an individual contract or group of contracts does not permit recovery of corporate office expenses is not a reason to exclude the operating segment performing the contract(s) from the base of allocation. Once an appropriate base for distributing indirect costs has been accepted, it should not be fragmented by removing individual elements (FAR 31.203(c)). Also see CAS 410.50j for a discussion of special allocations. To the extent that the home office provides necessary support for the segment, a proportionate share of the residual expenses should be allocated to that segment.

6-606.6 Allocation Bases for Residual Corporate/Home Office Expense to GOCO Activities

a. Special attention should be given to the appropriate allocation of residual corporate/home office expense to government-owned contractor-operated (GOCO) plants. Contractor's GOCO activities are usually conducted on a basis substantially independent of supervision by higher corporate echelons. In addition, less administrative support is usually received from the central office since many corporate administrative services are paralleled by the GOCO administrative activity. In such circumstances, it would not be equitable to distribute a share of all the higher level supervisory or administrative expenses to these plants on a proportionate basis by any of the methods commonly used to allocate residual corporate/home office expense to segments.

b. Each auditor at a GOCO plant will provide the corporate/home office auditor information on the nature and extent of administrative functions performed at the GOCO plant. The auditor at the

home office will review with the contractor whether portions of the home office expenses duplicate these functions, so that a suitable corporate allocation structure is developed for GOCO activities.

c. If it is appropriate to allocate less residual expenses to a GOCO, the contractor may accomplish this by developing two expense rates as follows: (1) a basic rate reflecting those corporate expenses which apply to all work of the contractor including GOCO plant operations, and (2) a rate in addition to the basic rate reflecting those corporate expenses which apply to all work of the contractor except GOCO plant operations.

Figure 6-6-1 is an example of the development of such rates.

d. Where CAS 403 applies, any special allocations of residual corporate/home office expenses to GOCO activities are established by agreement between the contractor and the government in accordance with CAS 403.40(c)(3) and 403.50(d). Only a contracting officer may execute such an agreement, but the contract auditor will normally evaluate the proposed method before an initial agreement. The auditor will evaluate the continuing appropriateness of the contractor's method during each audit cycle, and advise the contracting officer if any formal agreement warrants revision.

Figure 6-6-1 (Ref. 6-606.6)
SAMPLE OF CORPORATE EXPENSE RATES — GOCO ACTIVITIES

	Totals	Rate Calculations	
		Basic	Additional
Residual Corporate Expenses:			
Basic (applicable to all segment activities)	\$ 20,000	\$ 20,000	—
Balance (applicable to non-GOCO segment activities)	\$ 40,000	—	\$ 40,000
	<u>\$ 60,000</u>	<u>\$ 20,000</u>	<u>\$ 40,000</u>
Base of Allocation:			
GOCO segment activities	\$ 200,000	\$ 200,000	—
All other segment activities	\$ 800,000	\$ 800,000	\$800,000
	<u>\$1,000,000</u>	<u>\$1,000,000</u>	<u>\$800,000</u>
Rates	—	<u>2%</u>	<u>5%</u>

Note: In this illustration, the corporate expense rate applicable to GOCO activities is 2%; the rate applicable to other activities of the contractor is 7%.

6-607 Allocation of Indirect Costs to Facilities Contracts

6-607.1 Introduction

The procurement or maintenance of facilities for the account of a third party is not normal to the business operations of most contractors. Therefore, indirect cost allocations related to such efforts

under a government contract may be governed by special provisions in the contract. (The rationale for such special provisions is more fully presented in FAR 31.106 and in DoD CAS Working Group Paper No. 79-24. This paragraph deals mainly with facilities contracts (a special type of contract as described in FAR 45.301 and 45.302-2), but similar special provisions may also be included

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in other types of contracts (FAR 45.302-3). In such cases, the same guidance would apply.

6-607.2 Audit Policy

Audit treatment of indirect cost allocations to facilities contracts will be as follows:

a. Recommendations for preaward pricing, including forward pricing rate agreements, will be based on the cost principles and standards that apply to the preponderance of the contractor's anticipated work for the future period involved (usually FAR and CAS).

b. After contract award, indirect cost allocations will be based on the contract provisions (including pertinent advance agreements) to the extent feasible.

c. The auditor should follow the procedures in 3-204 if there are conflicts among cost allocation requirements in different contracts or advance agreements with the same contractor, or if special provisions are inconsistent with applicable procurement regulations including Cost Accounting Standards.

6-607.3 FAR Cost Principles

Facilities contracts will normally provide that costs will be determined in accordance with FAR 31.106. FAR 31.106-2 states a general rule that (1) a contractor's usual allocation method will be varied as necessary to produce an equitable result under facilities contracts and (2) the variation(s) will be accounted for by adjusting the indirect cost pool(s) and distribution base(s). It also states the desirability of an advance agreement (advance agreements are discussed in FAR 31.109) on the subject. FAR 31.106-2 gives specific criteria for allocating indirect manufacturing and plant operational costs, summarized as follows:

a. Indirect manufacturing and plant operation costs that relate mainly to direct labor or indirect plant maintenance labor are not allocable to the purchase of facilities, or services in connection therewith, from outside sources on a completed basis. (See FAR 31.106-2(c)) However, certain indirect costs may have a beneficial or causal relationship and should be appropriately allocated to the acquisition of such facilities. (See

FAR 31.106-2(e) and, if applicable, CAS 418.)

b. Work on facilities installation or rehabilitation, performed by plant maintenance labor, is not subject to an allocation of unrelated indirect costs such as costs of (1) supervision of direct production labor, (2) depreciation and maintenance of production machinery and equipment, and (3) storage of raw material or finished goods. (See FAR 31.106-2(d).)

c. The contractor's usual indirect cost allocations for production apply to any facilities contract work that (1) uses the contractor's direct labor and manufacturing processes, and (2) involves facilities items that are used in the regular course of the contractor's business. (See FAR 31.106-2(d).)

6-607.4 G&A Allocation Per W.G. 79-24

DoD CAS Working Group Paper No. 79-24 (W.G. 79-24) states DoD policy on special allocation of segment G&A expense to facilities acquisition costs under facilities contracts. It states that facilities acquisitions usually receive less benefit from G&A expense than do other contracts, and requires a special allocation when this is the case. The paper applies CAS 410.50(j) to such situations. A DoD procurement office would likely follow the same approach in the event of a non-CAS-covered facilities acquisition program, as an implementation of the general policy expressed in FAR 31.106-2. NASA and other non-DoD procurement offices may apply similar principles. Under W.G. 79-24, the contractor's normal G&A allocation will apply to facilities maintenance effort; the special allocation is only for the costs of contractor acquired government funded facilities. Where needed, the contractor should (1) develop an appropriate allocation method for facilities contracts and any similar non-government work and (2) propose and cost all such effort as consistently as possible.

6-608 Evaluation of Indirect Costs**6-608.1 General Guidance**

a. Indirect costs are incurred as a result of business decisions made at all levels of

management. These decisions may be based on established policies or may be a manager's choice among several options for achieving an objective. The auditor should consider the reasons underlying management decisions when a specific cost item and the government's interest in the total allocated portion of indirect costs is significant.

b. The audit objectives are to (1) ascertain the extent to which the contractor's policies are being implemented at the operating level, (2) determine whether the contractor is maintaining adequate control over the level of indirect expenditures, (3) ascertain and evaluate significant fluctuations in the ratios of the accounts to the allocation base, and (4) determine whether the contractor has excluded from expense pools costs which are unallowable because of the provisions of law, regulations, or the contract; unreasonable in nature or amount; inapplicable to the government operations; or inapplicable to the indirect cost pool or period being reviewed. This section provides guidance on the techniques for selecting accounts to be analyzed and the basis for questioning costs.

c. A transaction testing plan should be prepared to document evaluation of the contractor's annual incurred cost proposal. This plan should fully consider all significant costs, both direct and indirect. The auditor should ensure that all transaction testing MAARs and any other MAARs not accomplished during the preliminary steps of the annual incurred cost audit or other field work are addressed in the transaction testing plan. The extent of required transaction testing should be based on consideration of all the following factors:

- (1) assessment of control risk,
- (2) prior audit experience (including the documented risk shown on the ICAPS),
- (3) materiality,
- (4) reliance on the work of others, and
- (5) results of the preliminary audit procedures

d. Regardless of the assessed level of control risk at a major contractor, the auditor should perform substantive tests for significant account balances and transaction classes. Substantive tests in-

clude both analytical procedures such as the comparative analysis MAARs (e.g., 8 and 15) and transaction testing. The auditing standards do not envision any circumstance where the assessed level of control risk would be low enough to eliminate the need for substantive testing, however, the level of substantive testing should be tailored based on the criteria discussed in c. above. Accounts/transactions to be tested can be selected considering the techniques described in 6-608.2. Sensitive accounts should be audited frequently, or on an annual basis as appropriate, while less sensitive accounts should be selected on a rotating basis.

e. At higher risk nonmajor contractors and at those nonmajor contractors where there is no recent audit experience, transaction testing of significant account balances and transaction classes that are considered medium or high risk should be completed each year. At documented low risk nonmajor contractors transaction testing is required every other year for single year audits, and for at least one of the years for multi-year audits, to determine and document that the contractor continues to be low risk. The low risk determination and the subsequent level of transaction testing (or conclusion that transaction testing is not required in the current year) must be documented in the working papers See 6-603.6 for additional guidance.

f. Movement to an ACMS (see 14-800) can encompass a large number of cost pools (see 6-606.2). Successful accomplishment of reviews encompassing a large number of pools depends upon the application of the basic audit concepts of materiality and risk assessment during the audit planning stages. First, look for the strength of internal controls over the system itself (see 5-1000 Indirect/ODC System Reviews). Then, determine the areas of risk and materiality. Are they concentrated in several pools, or are they concentrated in several key accounts spanning all pools? Place audit resources where a vulnerability assessment indicates the greater risk and materiality. Using a combination of auditor judgment and statistical sampling techniques, review the high-risk/materiality pools. Con-

sider reviewing the high-risk/materiality pools more frequently and the low-risk pools on a rotating basis. As an alternative, determine if there are sensitive accounts which span all pools, and perform the review focusing on these accounts.

In addition, determine if the contractor's internal auditors will also be performing reviews on the cost pools. Coordination with these auditors, after determining the coverage and reliability of their efforts, may provide assistance and minimize potential duplication. Finally, audit tools, such as downloading information from the contractor's computer to assist the audit process, hold great promise as an effective approach to manage a review of a larger number of cost pools efficiently.

6-608.2 Techniques for Account Selection

The basis for determining the specific areas to be selected for detailed review and testing and the scope of the review should be determined by plant observations, review of management decisions, and account analysis.

a. Plant Observation. Plant observations are an integral part of the audit of indirect costs. They provide valuable indicators of accounts to be analyzed and/or areas of high risk. In performing the observations of a contractor's plant, the auditor should consider the following:

(1) When the contractor maintains segregated cost centers, the auditor should observe the manner in which physical and accounting segregation is accomplished, particularly when government contracts and commercial production are performed in the same general area. The extent of observation should be influenced by the degree of control established by the contractor to preclude the interchange of operations. The observations should assist in ascertaining which pools, cost centers, and accounts require the greatest emphasis during the review.

(2) The auditor should determine the manner in which the contractor establishes new production lines and should inquire into all aspects of a new line, noting any similarity between the contemplated production and the production currently in process. Again, this will

assist in determining the pools, cost centers, and accounts requiring the greatest emphasis during review.

(3) The auditor should observe the existence of idle facilities and determine whether idleness results from ordinary maintenance, lack of work, temporary machinery breakdown, or faulty production planning. Guidance on the allowability of idle facilities and capacity is provided in FAR 31.205-17.

(4) The auditor's physical observation program should include inquiries into the reasonableness of rework and scrap generated. When it is determined that there is an unreasonable amount of rework or scrap, the auditor should ascertain the causes. The review of rework and scrap costs may require the assistance of government technical personnel.

(5) The auditor should observe the contractor's manufacturing facilities to develop a better understanding of the contractor's manufacturing processes and monitor the trends in manufacturing practices and processes (5-108d). Some contractors have accomplished substantial technological advancements on the factory floor. These changes in manufacturing operations can cause changes in the flow of costs. Factory observations should assist in identifying the expense pools requiring further review.

b. Effect of Management Decisions. The auditor should review executive or directors' minutes, company newsletters, and internal and external audit reports for indicators of accounts to be reviewed. These may disclose audit leads, such as the following:

(1) a lag in reducing indirect costs during periods of declining production, including the retention of supervisory and technical personnel when their services are not required at that time or in the foreseeable future,

(2) unwarranted increases in the number of and in the salaries of executives, indirect personnel, and engineers,

(3) the imposition of additional tiers of supervision without apparent need except as a means of retaining technical and supervisory personnel,

(4) continuing liberalization of fringe benefits as a means of recruiting and

retaining technical and administrative personnel,

(5) increased depreciation costs, attributable to high-cost plant expansion or changes in the method of computation,

(6) the inclusion of depreciation of idle or excess facilities during a declining production period,

(7) the leasing of facilities under "sale and leaseback" or "lease in lieu of purchase" agreements in excess of ownership costs,

(8) unusual increases in expenses such as plant rearrangement, rehabilitation, relocation, and leasehold improvements,

(9) expansion of training programs, recruitment programs, and public relations expenses,

(10) unusual increases in contractor initiated research and development programs and bid proposals, particularly during periods of declining production,

(11) investments in automation, modernization of manufacturing facilities, or mechanization,

(12) a major shift in the nature of or the methods used in the production processes,

(13) increasing costs for maintaining or overhauling old productive equipment in lieu of investing in new equipment, and

(14) internal control weaknesses disclosed by internal or external audits.

In addition, unallowable, unreasonable, excessive, or incorrectly classified costs may be generated as a result of a contractor's policies and management decisions underlying the policies. (See 6-604 for comments on the review of policies, procedures, and internal controls.) For example, a contractor's policy for recording costs may be designed to provide flexibility in charging engineering costs directly to contracts, IR&D and B&P, or to overhead depending on monetary limitations of contracts or advance agreements. When a contractor's policy is questioned, the auditor should evaluate the probable consequences of continuing the questioned policy and make appropriate recommendations. Such cases may be reportable under the provisions of 4-700 (detection and reporting of fraud, other unlawful activity, or improper practices).

c. General Account Analysis

(1) Nomenclature Review. Using a copy of the contractor's post-closing trial balance, which has been reconciled in accordance with the guidance in 6-609, the auditor should select for thorough analysis those accounts which are new and/or significant in amount, vary from developed trends, or which on the basis of nomenclature review or past experience appear to be sensitive in nature and likely to contain questionable costs. However, categories of indirect expense should not be accepted or rejected solely on the basis of a nomenclature review. The actual content of accounts being evaluated must be established through testing of transactions.

(2) Comparative Analysis. The auditor should also compare the amounts of the various accounts with the amounts expended in prior years and the amounts shown in the current year's budget. The comparisons should disclose: (a) whether there have been significant changes in the dollar amount of individual expense items which may not be comparable to a change in the level of operations; (b) whether there are unexplained differences which may require a more intensive review, additional testing, and verification; (c) whether management is maintaining control over expenditures by periodic comparisons with budgeted amounts; (d) whether there have been reclassifications of costs or changes in cost accounting practices; and (e) whether the expense is recorded in the proper account identified with the cost center, department, or expense pool which derives the benefit. When the pattern indicates a tendency for indirect costs to increase in comparison to direct costs, the auditor should determine the factors which are contributing to the increases (see the list of factors affected by management decisions in 6-608.2b above). These comparative analysis procedures will satisfy MAAR 15. Follow-up and resolution of discrepancies noted in the foregoing analyses and the related testing of transactions satisfies MAAR 16. The review of account detail and individual transactions must include a determination of the sources of journal entries and testing to

ensure propriety. These procedures will satisfy MAAR 20.

(3) Quantitative Methods. The use of graphic and computational analysis techniques can be helpful in the review of incurred costs. The auditor may be able to detect trends or correlations which permit the focus of attention on indirect expense accounts, pools, departments, or other segments of cost which appear to be unreasonable or out of line. Further, sampling and EDP techniques (such as DATATRAK and other data retrieval software) will assist the auditor in selecting transactions for review. Consideration should be given to the use of these techniques during incurred cost reviews.

d. Specific Account Analysis. In addition to the areas discussed below, Chapter 7 discusses items of cost and accounting methods requiring special attention. This chapter should be reviewed to assure adequate coverage of any applicable items. Special attention should be given to the discussion of IR&D and B&P costs because of its general applicability at most locations. The auditor may also wish to refer to Supplement 3-S10 which provides illustrations of various types of disclosures resulting from audit reviews.

(1) Contingent Expenses. Items charged to indirect expenses, not representing actual costs but rather a provision for contingencies, should be excluded from allowable costs. The auditor should refer to FAR 31.205-7.

(2) Indirect Labor. The audit of labor costs is discussed in Section 4 of this chapter. Recruitment costs are also discussed in Section 4 because they are closely related to the budgeting of labor costs and the determination of personnel requirements.

(3) Indirect Material. Priced or quantitative year-end inventory records should be reviewed to determine whether increasing costs indicate a trend towards a buildup of supply inventories. When contractors account for supply items as an expense at time of purchase, a comparison should be made of the amounts expended for various categories of supplies for the current and several preceding periods. Further discussion of the audit of material costs is contained in Section 3 of this chapter.

(4) Miscellaneous Charges. Miscellaneous charges to indirect costs may result from transactions of earlier or future periods. Included in this category are depreciation expenses, amortization of prepaid costs, and accruals of liabilities. Entries representing the write-off of prepayments or the establishment of accrued liabilities should be tested for propriety, reasonableness, allocability to the period, accuracy of computation, correctness of account distribution, and sufficiency of documentary support. The extent of verification should depend on the significance of the dollar amount and the extent to which the government participates in the cost.

(5) Miscellaneous Income and Credits. The auditor should review the contractor's financial statements, tax returns and adjusting entries in the general ledger or other subsidiary ledgers to identify any income or credits in which the government should share as well as to evaluate the exclusion of any adjustments not reflected by the contractor in contract costs. (See 6-609 for guidance on the verification of the base and pool to the accounting records.)

(a) The auditor should review the nature of all income received from sources other than the sales of the contractor's normal products. It is preferable that income, refunds, or credits applicable to a government contract, such as purchase discounts, income from sale of scrap, and rental income, be credited directly to the contract. However, if the income, refunds, or credits are not significant and the contractor's accounting treatment is equitable, these may be apportioned between commercial and government work through reduction of indirect cost pools or some other equitable method. The extent of audit in this area will depend on the effectiveness of the contractor's accounting procedures. Thus, the early identification of system weaknesses is of prime importance.

(b) Additional items which may be pertinent as credits or refunds under government contract costing include: refunds of various state and local taxes such as franchise, personal property, and income taxes; royalty expenses which have been accrued but remain unpaid;

workers compensation rate adjustments; and credits or reduction in rates of employer contribution to pension plans, death benefit plans, and similar group insurance plans, following accumulation of reserves built up through excessive rates, reversionary credits, or in some other manner. Accomplishment of this review satisfies MAAR 5 at the segment level; corporate level steps appear at 6-608.3b(1).

6-608.3 Basis for Questioning Costs

Expenses may be questioned based on allowability, allocability, and/or reasonableness. Supplement 3-S10 provides illustrations of various types of audit disclosures and Supplement 4-7S1 provides information on the "anti-kickback statute."

a. Allowability. Certain costs are rendered unallowable by provisions of pertinent laws, regulations, contract clauses, or mutual agreement and cannot be included in prices, cost reimbursements, or settlements under government contracts to which they are allocable. The contractor must certify that its indirect cost claim contains no unallowable costs. The contractor's claim should be reviewed to ensure that all directly associated costs have also been removed. (See 1-504.4a.)

(1) When certain costs are specifically identified in the contract as being unallowable, the contract may also provide criteria that must be met before a cost is considered allowable or limitations that cannot be exceeded. For example, the contract may state that subcontracts or travel must be approved by the contracting officer prior to the incurrence of the cost or it may state that overtime is allowable up to a specific dollar amount only. Contract briefs should be prepared to identify these clauses.

(2) CAS 405.40(a) requires that contractors affirmatively "exclude" costs which are either "expressly unallowable," as defined in CAS 405.30(a)(2), or mutually agreed to be unallowable. FAR 31.201-6 repeats this requirement for non-CAS-covered contractors. Examples of costs declared expressly unallowable by Federal statute or regulations are: (a) contingent fees (except payments to bona fide representatives), (b) entertainment

expenses, (c) fines and penalties, (d) costs of organizing or reorganizing a business enterprise, (e) contributions, (f) interest, (g) losses on other contracts, (h) certain types of advertising and business meetings, and (i) Federal income taxes. A description of these and other items and the criteria for a determination of allowability are provided in FAR Part 31 (see Appendix A), 6-700, and 8-405.

(3) Certain costs or portions of cost may be identified as unallowable based on advance agreements negotiated by the ACO, such as IR&D and B&P.

b. Allocability. Costs may be questioned because they are not allocable to government contracts. Cost Accounting Standards provide criteria on the allocability of costs for CAS-covered contracts. For non-CAS-covered contracts FAR provides certain criteria. The following are examples of allocability issues.

(1) Out-of-Period Costs. In addition to recognizing the relationship of an incurred expense to its objective, the auditor must relate the time factor (period to which the expense is applicable) in the manufacturing process. Not all expenses incurred during a given period may be allocable in their entirety to the items produced during that period. Therefore, the audit effort should be directed to ascertaining whether costs such as indirect labor, payroll taxes, vacation expense, retirement accruals, bonuses, insurance, maintenance and repairs, depreciation, amortization of leasehold improvements, and similar indirect expenses included in the indirect cost accounts have been properly accrued or deferred. The object of the test is to disclose those indirect costs which have been assigned to a current period when the cost was incurred for the purpose of benefiting a future or past period. Year-end adjustments and adjustments involving prior cost periods must be reviewed to determine materiality and applicability to current costs. Year-end adjustments may have a significant effect on the expense pool or bases for the allocation of indirect costs. The auditor's review should insure that the contractor's year-end adjustments actually result in a more precise allocation of indirect expenses.

16-608.3b.

This analysis and the segment level steps at 6-608.2d(5) satisfy MAAR 5.

(2) Consistent Classification. Consistency in the composition of indirect cost pools must be considered in determining the validity of the indirect cost pool as a whole. When the contractor's procedures provide that specific items of costs are charged directly to government contracts, the auditor must, prior to accepting the residual costs (6-606.5b) in the indirect cost pool, ascertain whether similar costs are also charged directly to the commercial work. Items which can be identified directly with other classes of work must be excluded from the expense pools if items identifiable with government contracts are charged directly (see FAR 31.202 and 31.203 or CAS 402).

c. Reasonableness. FAR 31.201-3 defines reasonableness. A cost may be considered unreasonable because it was not incurred in the most cost-effective manner. For example, the contractor may be providing its own guard service when outside vendors may be able to provide the service at a lesser cost. Tests of economy and efficiency are performed during operations audit reviews.

6-608.4 Penalties for Unallowable Costs

a. Statute and Regulation. DFARS 231.70 implements 10 U.S.C. 2324(a)-(d), which requires that penalties be assessed if a contractor claims a cost in an indirect cost settlement proposal that is unallowable. The DFARS 231.70 applies to DoD cost-type and fixed-price-incentive-fee contracts in excess of \$100,000 issued after 26 February 1987. The 1993 DoD Authorization Act revised the penalty statute to state that it applies only to expressly unallowable costs. The new law is applied to all overhead proposals submitted on or after 23 October 1992, as well as to the proposals that were already submitted but for which an audit had not been formally initiated. DFARS is being revised to implement the new law.

b. Penalties. The penalties are assessed based upon unallowable costs being included in a proposal without regard to whether the government has actually reimbursed the unallowable costs. The penalties are collected from the contractor in addition to recovery of any indirect

cost previously paid in excess of the final rates. Even if an audit report has been issued or the rates have been negotiated, the government may still assess a penalty if it is subsequently determined that the claim included unallowable cost subject to the penalty provision. If such information becomes known to DCAA, it should promptly be reported to the contracting officer. It is the initial submission claiming the unallowable costs that establishes the contractor's liability.

c. External Reviews. When an external review (e.g., GAO) discloses questionable costs, FAOs should assist contracting officers by assuring they are aware of the external review results and providing any assistance needed to determine the applicability of penalties.

d. General Responsibilities. Regardless of whether the rates are audit-determined or procurement-determined, the ACO determines whether or not a penalty should be assessed and issues a demand letter to the contractor for the amount determined. The auditor is responsible for making recommendations concerning the appropriateness of penalties, and for providing assistance in computation of the paid portion of the disallowance for purposes of interest computation. The auditor has no authority to impose the penalty, recover it against subsequent public vouchers, or recommend the supplemental penalty.

e. Definitions

(1) Unallowable costs are defined in FAR 31.001. Specific criteria for determination of allowability and accounting for unallowable costs appear in FAR 31.201-2 and 31.201-6.

(2) "Cost determined to be unallowable before proposal submission" means (for purposes of the second-level penalty) that the contractor had a formal written determination (describing the particular unallowable costs) that became final prior to the submission. The DFARS gives several examples. The regulation specifies that unappealed DCAA Form 1s and contracting officer determinations constitute prior determinations of unallowability. Appealed contracting officer determinations are final when a board or court hearing the appeal issues its final opinion. The final opinion must relate specifi-

cally to the contractor. Precedents involving other contractors or similar costs will not be sufficient to sustain a second-level penalty.

(3) "Mutually agreed to be unallowable costs" must be specifically designated as unallowable by an agreement between the government and the contractor. Generally the agreement would be in writing and describe the costs in sufficient detail to conclusively identify the costs in future proposals or claims. Mere agreement or concession by the contractor to a reduced overhead rate in the settlement process does not constitute agreement on the treatment of specific elements of cost, unless those elements of cost are specifically identified in the agreement and determined to be unallowable costs.

(4) The term "expressly unallowable costs," as it is used in the penalty regulation effective 23 October 1992, includes only those costs that are expressly unallowable under a FAR or DFARS cost principle (FAR/DFARS Section 31.205). It does not include any costs that are unallowable because they violate a regulation or contract term unless such regulation or contract term is also included in the cost principles.

f. Audit Requirements

(1) The auditor should request that the contractor identify all contracts that contain or should contain the penalty clause in the submitted schedule of auditable contracts. Absence of the penalty clause in a contract does not prevent the government from assessing the penalty. A contractor is bound by the required clause even though the clause is inadvertently omitted, because the statute makes it a mandatory clause.

(2) The penalty statute and implementing regulations do not flow down to subcontracts. Auditors should not recommend penalties for subcontracts even though their prime contracts include the penalty clause.

(3) When a contractor division submits an indirect cost settlement proposal that includes unallowable costs subject to penalty, any such costs allocated to interdivisional work performed under another division's covered contracts are also subject to penalty.

(4) The corporate indirect cost submissions include home office expenses allocable to the divisions. Each division's allocable portion of the home office expenses are also included in the division's incurred cost submission. Since the divisions have the contracts that include the penalty clause, the penalty recommendation on the allocated home office expenses should be made in the audit report on the division's annual incurred costs. To assist the divisional auditor in making penalty recommendations, the corporate auditor should identify those costs subject to penalty in the corporate audit report.

(5) If the contractor has contracts that contain or should contain the penalty clause, the auditor must expand the report to specifically identify questioned costs that are subject to the first and second penalty levels. The exhibit note should contain sufficient information to show the factual basis for the penalty recommended. If a second-level penalty is recommended, the report should cite the specific prior determination relied upon for the recommended penalty. The reporting objective is to provide the ACO with the information necessary to determine which unallowable costs are subject to penalties and to allocate the penalties to covered contracts. Since the ACO determines whether a penalty is to be imposed, the auditor should not calculate the amount of penalty until requested by the ACO.

(6) Reporting requirements are further discussed in 10-500. Sample paragraphs to include in the summary of audit results appear in 10-504.4c, and the required information to include in the exhibits and schedules is discussed in 10-505f and g. An exhibit should be included identifying questioned costs by penalty level, amount, and percent of base subject to penalty (see Figure 10-5-3). To assist in the application of penalties for unallowable home office expenses, the audit report on the corporate costs should include a schedule showing the costs subject to penalty for each division (an example is included in Figure 10-5-4). The exhibit listing all auditable contracts should identify those contracts that contain or

should contain the DFARS penalty clause.

g. **Computation of Penalty.** When the ACO advises the auditor of his or her decision on disposition of a recommended penalty, the auditor should provide assistance, as requested, to calculate the actual penalties to be assessed to applicable contracts including the recommended period, rate, and base for assessment of interest using data gathered during the audit of the final rate settlement proposal.

(1) **Cost Portion of Penalty.** The cost portion of the penalty is associated with indirect costs that were proposed as part of indirect cost pools to be allocated over specified allocation bases. The penalized costs may be expressed as a rate applicable to the same allocation bases. Calculation of the assessed penalty requires identification of the portion of the allocation bases applicable to contracts with the penalty clause.

(2) **Interest Portion of Penalty.** In calculating the interest portion of the penalty consider the following:

(a) **Period.** If the unallowable costs were incurred and paid evenly over the fiscal year, calculate the applicable interest assuming all unallowable costs were paid at the midpoint. If the unallowable costs were not incurred and paid evenly over the year, the interest would have to be computed using weighted average techniques. If a demand letter was issued by the ACO, interest should not be computed after the date of the letter or the date of repayment by the contractor, whichever is earlier. The ACO uses different interest calculation procedures for the time period after the demand letter is issued.

(b) **Rate.** The rate specified by the Secretary of the Treasury according to Public Law 92-41 Cost of Money rate) is the interest rate to be used. If the end point of the interest computation period is unknown at the time the auditor is making the calculation, provide the interest incurred to the end of the current month and the monthly interest rate applicable to the outstanding balance of paid penalized costs so that the ACO may adjust the calculations as necessary when the ending date is known.

(c) **Base.** The base subject to interest penalty depends on the amount of penalized indirect cost that has been paid by the government. If the total amount of interim billings paid for the period is less than the total claimed indirect expenses, assume the contractor was reimbursed for its incurred indirect expenses in the following order:

(i) the allowable indirect costs agreed upon in the final rate settlement,

(ii) costs disallowed from the contractor's rates as part of the settlement process that are not subject to a penalty, and

(iii) costs disallowed in the rate determination that are subject to penalty.

h. **Recommendation of Penalties Based on Statistical Sampling Review.** If a statistical sampling application used to project questioned cost includes unallowable costs subject to the penalty, the portion of the sample subject to penalty will be projected to determine the questioned costs subject to penalty. The total recommended costs subject to penalty should be the point estimate of that projection. Audit report presentation of statistical sampling results should be in accordance with 4-605.

i. **Voluntary Management Reductions.** A contractor may not avoid a penalty by applying a voluntary management reduction that does not specifically identify the unallowable costs excluded from the proposal (see CAM 6-604.2).

j. **Multi-year Submissions.** The facts that the contractor knew or should have known at the submission date determine the penalty level to be recommended for a final indirect rate proposal. If a contractor has submitted one or more subsequent year's indirect cost proposals before the determination of unallowability on an earlier year's proposal, only the first level penalty would apply to those later years' proposals if they contain the same costs that are ultimately determined to be unallowable for the earlier year. A determination or agreement must be made before the submission of a proposal that a cost is unallowable for that contractor, for the second level of penalty to be applicable.

6-608.5 Specific Provisions Prior to 23 October 1992

a. Level of Penalties. There are three levels of penalties to be assessed:

(1) The first level penalty applies to any cost that is unallowable based on clear and convincing evidence. This penalty is equal to the amount of the disallowed cost plus interest on any such cost which was paid to the contractor.

(2) The second-level penalty applies to a cost subject to the first level penalty which was determined to be unallowable before the indirect cost proposal submission. This penalty is equal to twice the amount of such disallowed cost and is in addition to the first level penalty. The total penalties applied to such costs would equal three times the amount of the disallowed costs plus interest on the amount actually paid.

(3) The third penalty may be applied to any final indirect cost settlement proposal subject to the first or second level of penalty. It is assessed in an amount up to \$10,000 as a supplement to the other penalties.

b. Standard of Evidence for Unallowable Costs

(1) Standards of evidence are standards set for court hearings or appeals to define the degree of certainty required to sustain a verdict on an issue. For most audit issues the auditor must meet the standard of "preponderance of the evidence" to sustain questioning a cost. This means that someone reviewing the evidence would be more likely to agree with the audit position than the contractor position in a dispute on the issue. In essence this standard requires that the weight of the evidence should be greater on the audit side than on the contractor's side.

(2) "Clear and convincing" evidence is a higher standard than the "preponderance of the evidence," but is a lower standard than "beyond a reasonable doubt" used in criminal proceedings. Characteristics of an audit position based on "clear and convincing" evidence would include a high probability that the questioned costs would be sustained if appealed and generally be reflective of evidence which a reasonable person would accept as determinative on its face;

evidence which, if accepted as accurate, would require no further explanation for a reviewer to determine the appropriate outcome. A close judgment call or "gray area" will not meet the test.

c. Contractor Errors and Withdrawals

(1) Neither the law nor the regulation provides an exception for unallowable costs included by mistake. The auditor must recommend any penalty which would be applicable to an unallowable cost claimed in an indirect cost settlement proposal even if the cost was included as the result of a clerical or other inadvertent error. The penalty is based on the claim itself, not the intention of the contractor in making the claim. The law and regulation specifically state that these penalties are in addition to any other penalties associated with the disallowed costs, e.g., fraud penalties. When it is obvious that a submission contains an error which results in the inclusion of an unallowable cost in the final indirect cost claim, the error should be described in the audit report with sufficient detail to allow the contracting officer to determine if the error resulted in an increased claim against the government.

(2) A contractor may not avoid a penalty on a cost claimed in a final indirect cost proposal by withdrawing the submission, removing the unallowable cost, and resubmitting it. The auditor should review any costs removed by a contractor in a subsequent proposal submission for costs subject to penalty and recommend applicable penalties for any contractor removed costs as part of the audit report on the final submission.

6-608.6 Specific Provisions on or After 23 October 1992

a. Level of Penalties. There are two levels of penalties to be assessed:

(1) The first level penalty applies to costs that are expressly unallowable. This penalty is equal to the amount of expressly unallowable costs plus interest on such costs which were paid to the contractor.

(2) The second-level penalty applies to costs which were determined to be unallowable before the indirect cost settlement proposal submission. This penalty is equal to twice the amount of such disallowed costs.

b. Standard of Evidence for Unallowable Costs. Costs must be expressly unallowable under a specific FAR or DFARS cost principle or mutually agreed to be unallowable to apply the penalty. Costs that are unallowable solely because they are unreasonable or unallocable do not meet the standard under the new law.

c. Waiver of Penalty. ACOs may waive penalties in any of the following situations:

(1) The contractor withdraws an overhead proposal before the formal initiation of an audit and the contractor submits a revised proposal;

(2) The amount of unallowable costs under the proposal that are subject to the penalty is \$10,000 or less; or

(3) The contractor demonstrates, to the cognizant ACO's satisfaction, that the cost was an inadvertent error and that the contractor has established an adequate internal control system to prevent the inclusion of expressly unallowable costs in its final overhead proposals. The following items should be taken into consideration in reviewing the contractor's demonstration:

(a) The contractor has established an adequate internal control structure that provides assurances that unallowable costs subject to penalties are not included in the incurred cost proposals (this could also include satisfactory participation in self-governance programs); and

(b) The unallowable costs subject to the penalty were inadvertently incorporated into the proposal; that is, their inclusion resulted from an unintentional error, notwithstanding the exercise of due care.

d. Formal Initiation of Audit. The new law permits the contractor to withdraw its overhead submission and avoid penalty if such withdrawal is before the formal initiation of an audit. An audit is considered formally initiated if one of the following conditions exists.

(1) It is communicated to the contractor in writing that audit work has started.

(2) An entrance conference was held.

(3) Field work was initiated. This applies even if the audit work was started on only one element of the overhead costs, e.g., travel, pension, and compensation.

(4) Other verifiable evidence exists that an audit was initiated and the contractor was aware of that fact. Verifiable evidence includes dated letters to the contractor requesting information pertaining to a claimed cost or responses from the contractor to such requests.

e. Evidence of Formal Audit Initiation. The key element for the formal initiation of an audit is the existence of verifiable evidence that the contractor is aware that an audit has begun. FAOs should advise the contractor that the preliminary audit work has begun in a letter confirming the scheduled entrance conference.

6-609 Verification of Allocation (Activity) Base and Pool

Guidance on the selection of the allocation (activity) bases is in 6-606. Guidance on the review of the costs included in these bases (labor, material, other direct costs, and indirect costs) is in this and the following sections of this manual: 6-400, 6-300, 6-500, and 6-608. Guidance on the policies, procedures, and internal controls is in Chapter 5 (accounting system, allocation methods, preparation of submissions, etc.). Guidance on the verification of the base and pool is provided in this section.

6-609.1 Reconciliation to Records

The auditor should review incurred cost submissions to verify that the costs claimed reconcile to the contractor's job cost subsidiary ledgers or other comparable records by major cost element (material, subcontracts, intracompany charges, other purchases, labor, indirect, other charges and credits, etc.). The subsidiary ledgers should be reconciled to general ledger control accounts, certified financial statements, labor reports, tax returns, factory records, depreciation schedules, and any other financial, statistical, or management reports or records which will provide assurance that the costs have been properly presented. Accomplishment of this review satisfies MAAR No. 2 and a portion of MAAR No. 14.

6-609.2 Verification of the Base

Completion of the following reviews in conjunction with 6-609.1 above will satisfy MAAR No. 14.

a. The auditor must be assured that the costs (or hours or other factors) included in the activity base comprise all costs (or hours or other factors) contemplated when the base was selected, and no other. For example:

(1) If direct labor cost is selected as a base for distribution of manufacturing overhead, the following items should be considered: Is the total overtime pay to be included or is the base to include straight-time pay only? If the company pays a bonus for night shift work, is this bonus included in the base? Does off-site labor take a full share of the allocation? Is "purchased labor" in the base, if worked at the contractor's plant? If worked at the vendor's plant? Is premium pay for hazardous duty excluded?

(2) Does the base for distribution of home office expenses include the activity of subsidiary companies (domestic and foreign) when applicable?

(3) Has the contractor charged salaries or wages of engineering personnel devoted to its own engineering projects to overhead accounts, or otherwise excluded them from engineering direct labor bases? If so, such costs should be reclassified to the direct engineering labor base.

(4) For CAS-covered contractors, a comparison should be made with the Disclosure Statement, section 4, to assure the adequacy of the description of the bases. Disclosure Statement inadequacies and noncompliances should be reported in accordance with the guidance in 8-208g and 8-302.7, respectively.

b. Composition of the bases should be compared with the preceding period. If there are differences, the effect of the changes should be determined and the reasonableness and equity of the results evaluated.

c. Once an appropriate base for distributing indirect costs has been accepted, it should not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as gov-

ernment contract costs (FAR 31.203(c)). For example, unallowable overhead costs, including those voluntarily deleted by the contractor, must remain in the cost input base so that they absorb their portion of the G&A cost.

d. The portion of the base which applies to cost-type government contracts should be reconciled with the contractor's billings (interim and final reimbursement claims). This is significant because the adjustments resulting from the determination of actual indirect costs will be based on the data contained in the claims submitted (see 6-1000 for guidance on interim and final reimbursement claims). The preparation of cumulative cost summaries will facilitate this reconciliation. These cumulative cost summaries should be provided with the contractor's indirect expense proposal.

e. Movement to an ACMS (see 14-800) can encompass the use of new types of allocation bases (see 6-606.3). During review of an allocation base, determine what the base measures (resource consumption, output), and then determine if the contractor is capable of objectively measuring the base now and in the future. Because the proposed base may represent a totally new method of cost allocation, the contractor may not be able to support the proposed base with accumulated historical data. The contractor may have to support the proposed base with a combination of documentation such as production projections, historical data, employee interviews, manufacturer machine capability and specifications, and engineering analyses. Auditors should be open to verifiable forms of documentation which may be generated by the new system. Next, determine if the base provides for an equitable distribution of cost and if there is a beneficial or causal relationship between the pool and the base. Given the evolution to a strong technological orientation, the auditor may require technical assistance in evaluating the appropriateness of the proposed allocation bases. For example, one contractor proposed to allocate fabrication costs on operation movements. The operation movements encompassed functions which varied in difficulty and process time. However, with technical assistance

it was determined that operation movements were an equitable base.

6-610 Verification of Rate Calculation and Indirect Cost Distribution

6-610.1 General Guidance

a. When the indirect cost pools have been verified and the activity bases for distribution have been accepted, the auditor should then verify the accuracy of the rate calculation and the distribution of indirect costs to government contracts. Completion of this review satisfies MAAR No. 19.

b. Contractors may develop indirect cost rates (pool/base) for application to the contract base, or may distribute indirect cost on a percentage basis (contract base/total base). Both methods produce the same results. There is no specific criterion for the number of decimal places by which to extend the rate. Generally, rates are extended to two places past the decimal point; however, if the costs are significant, the rates may need to be extended further.

6-610.2 Quick (Early) Closeout Procedures (See 6-1009)

a. During the course of a fiscal period, many contractors perform numerous government contracts as a continuing

part of their activities. The direct and indirect costs incurred on an individual contract in the last fiscal period of its performance may be relatively small in amount, particularly if the contract is physically completed in the early portion of the fiscal period. In such cases it is generally mutually advantageous to the government and the contractor to expedite the indirect cost settlement and close such contracts as soon as possible without waiting until after the end of the fiscal period and the subsequent final determination or negotiation of indirect cost rates for the entire period. Certain special conditions and requirements for closing terminated and completed cost-reimbursement type contracts on an expedited basis are presented in 12-407 and 6-711, respectively.

b. Because of the small amount of contract costs involved, the use of these procedures should result in only an insignificant difference in the amount of indirect cost applied to the contract for the closeout period as compared with the amount which would have been applied if the contract were not closed until after the annual or other periodic rate was established. Consequently, except as stated in paragraph 12-407, no adjustment to compensate for any such difference need be made in computing the periodic indirect cost rate to be applied to other contracts performed during the period.

6-700 Section 7 — Administrative Procedures for Establishing Indirect Costs**6-701 Introduction**

This section describes the administrative methods and procedures commonly used to establish interim billing rates and final indirect cost rates. Because indirect costs can only be definitely established at the end of the contractor's fiscal accounting period, special procedures are needed to reimburse contractors on an interim basis for the approximate indirect costs incurred and then to finalize the indirect cost rates after the end of the contractor's accounting period.

6-702 Definition of Terms

a. The term indirect cost means any cost not directly identified with a single final cost objective (i.e., a function, contract or other work unit for which cost data is measured), but identified with two or more final cost objectives or an intermediate cost objective. It includes, but is not limited to, the general groups of indirect cost such as those generated in manufacturing departments, engineering departments, tooling departments, general and administration departments and, if applicable, indirect costs accumulated by cost centers under these general groups. For contractors using fund accounting systems (mainly educational institutions), the term includes, but is not limited to, the general groups of expenses such as general administration and general expenses, maintenance and operation of physical plant, library expenses and use charges for buildings and equipment. (See FAR 31.203 for further discussion of indirect costs.)

b. The term final indirect cost rate means a percentage or dollar factor which expresses the ratio of the allowable indirect expenses to the direct labor, manufacturing cost, cost incurred or other appropriate base for the contractor's fiscal period customarily used for the computation of indirect cost rates. Unless subject to a qualification related to an ASBCA case or similar item, once established and agreed upon by the government and the contractor, an indirect cost

rate is not subject to change. Final indirect cost rates are usually established after the close of the applicable fiscal period under one of the methods described in 6-703.

c. A billing rate is an indirect cost rate established temporarily for interim reimbursement of incurred indirect costs and is adjusted as necessary pending establishment of the final indirect cost rates. Billing rates are intended to approximate the expected final rates. The contracting officer or auditor responsible for determining the final indirect cost rates ordinarily will also be responsible for determining the billing rates.

6-703 Approaches to Establish Indirect Costs

In general, billing rates and final indirect cost rates are used in reimbursing indirect costs under cost-reimbursement contracts and in determining progress payments under fixed-price contracts. Except for cost-sharing contracts, contracts with rate ceilings, and use of the quick-closeout procedures (see 6-711.1), methods commonly used to establish indirect costs are as follows:

a. By Audit Determination-The actual final indirect cost rates are determined by the auditor as a result of audit. Under this method, the auditor's determination is definitive, subject to the appeal procedures available to the contractor. The procedures for audit determination are in FAR 42.705-2/DFARS 242.705-2.

b. By Contracting Officer Determination-The final indirect rates are arrived at by negotiation between the government and the contractor based on a proposal submitted by the contractor and an advisory indirect cost audit report issued by the contract auditor. The locations at which rates will be determined by contracting officers, the procedures for the conduct of negotiations and the applicable contract clauses are stated in FAR 42.705-1/DFARS 242.705-1.

c. As an alternative to b. above, research contracts with educational institutions may provide for predetermined

fixed rates and/or negotiated fixed rates with carryforward provisions. As in b. above, the rates are established by negotiation and contractual agreement between the government and the contractor to cover a specified future period (see Chapter 13).

6-703.1 The DoD Approach

Until August 1985, each DoD contract would, by its terms, prescribe the method (usually either audit determined or negotiated indirect cost rates) to be used in reimbursing the contractor for its indirect costs. At that time authority and responsibility for settling all DoD final indirect cost rates (except those related to educational institutions, nonprofit organizations, and state or local governments) were transferred to DCAA. In June 1988, responsibility for settling final indirect cost rates at major contractor locations was returned to contracting officers. Procedures for establishing indirect cost rates for DoD contracts related to educational institutions, nonprofit organizations, and state or local governments are in FAR 42.705-3 through 42.705-5. Essentially, these rates are established by contracting officer negotiation using applicable Office of Management and Budget guidelines.

6-703.2 Non-DoD Procedures

FAR 42.7 provides that final indirect cost rates on non-DoD contracts will be established by either audit determination or contracting officer negotiation as provided by the terms of the applicable contract. Audit recommendations concerning non-DoD contracts are usually advisory in nature as most of these contracts give the contracting officer responsibility for establishing the final indirect cost rates. The guidance in 10-211 and 10-507c pertaining to the distribution of indirect cost audit reports should be followed to ensure that all interested non-DoD parties receive a copy of the report. Additional comments on special administrative procedures related to non-DoD agencies are given at 15-100.

6-704 Applicability by Contract Type

6-704.1 Cost-Reimbursement Contracts

a. Cost-reimbursement contracts provide for payment of the allowable incurred costs (including interim/final indirect costs) to the extent prescribed in the contract. These type contracts establish an estimate of total cost for obligating funds, which also serves as a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer. These contract provisions are set forth in an "Allowable Cost and Payment" clause (FAR 52.216-7) as provided in FAR 16.307. A major portion of this clause discusses the administrative procedures to be used in paying interim indirect costs and establishing final indirect cost rates. In general, this portion of the clause provides that:

(1) Final indirect cost rates will be established as detailed in FAR 42.7.

(2) The contractor shall submit within 90 days after the close of its fiscal year, its proposed final indirect cost rates based on its actual cost experience for that period.

(3) Once agreement is reached, a written understanding shall be executed setting forth the final rates.

(4) If agreement is not reached on the final cost rates, this shall be a dispute within the meaning of the Disputes clause.

b. In addition to the "Allowable Cost and Payment" clause, FAR 42.802 provides that cost-reimbursement type contracts will also include the clause at FAR 52.242-1, Notice of Intent to Disallow Costs. This clause gives the procedures that can be used in disallowing costs if the government questions a cost.

c. Indirect costs may be reimbursed under cost-type contracts either by (1) the actual cost method (audit determination), (2) negotiated rate method (contracting officer determination), or (3) negotiated fixed rates with carryforward of under or over-recovery provisions under R&D contracts with nonprofit educational institutions (see Chapter 13). Under certain conditions, prospective indirect cost fixed rates may be used under a cost-sharing contract. In addition, indi-

rect cost rates may be negotiated and used for stated periods of time in determining the amount of indirect expenses to be included in cost proposals for negotiated cost-type and fixed-price type contracts, contract change orders, man-month rates for technical service contracts, and other similar contracts.

6-704.2 Fixed-Price Contracts

The provisions of FAR 42.7 (Indirect Cost Rates) also apply to fixed-price contracts if the contractor requests progress payments or its fixed-price contracts include price adjustment provisions (e.g., incentive contracts). In these cases, the billing and final indirect rates will be established using the same administrative procedures as for cost-reimbursement contracts.

6-705 Interim Reimbursement

6-705.1 Billing Rates

a. The government allows interim payments, if authorized by the contract, during contract performance by use of either SF 1443 (progress payments) for fixed-price contracts, or by SF 1034 (public voucher) for cost-type contracts. The contract itself will designate the manner of billing. Reimbursement of indirect costs in these payments is generally made through billing rates that are established to approximately equal the expected final indirect cost rates. These billing rates are used for interim reimbursement purposes until settlement is reached on final rates after the end of the contractor's fiscal year. Once the final rates are established, an adjustment is made for any variance between the billing and final rates. (Before final rates are established, the billing rates may be prospectively or retroactively revised by mutual agreement, at either the government's or contractor's request, to prevent substantial overpayment or underpayment.)

b. Where a change in billing rates is indicated, prompt action should be taken to obtain adjustment. In reviewing any proposed changes in billing rates, the auditor must, of course, give due consideration to any access to records problems, possible mischarging, more recent indica-

tions of unacceptable costs, etc. To simplify interim indirect cost claim computations, billing rates should be calculated using the least number of decimal places that will properly consider the impact of the rates on contract costs. The auditor's rate calculations will be appropriate to the circumstances regardless of how the contractor submits its rates.

c. FAR 42.704 provides that the contracting officer or auditor responsible for determining the final indirect cost rates shall usually also be responsible for determining the billing rates. In addition to FAR 42.704, guidance related to evaluating and establishing billing rates and reporting on them is in 9-704 and 10-506.3.

d. After the end of the contractor's fiscal year, the auditor needs to compare the interim billing rates with the year-end recorded allowable rates (considering any historical audit exceptions) to determine if the billing rates need to be adjusted. The auditor should not wait to receive the final indirect cost submission which is not due until 90 days after the end of the fiscal year to make these comparisons. At contractors where we have a resident or suboffice, the comparison should be done as soon as practicable after the year-end closing. At smaller contractors where we do not have an in-plant office, we should request that the contractor mail copies of the summary cost records showing the year-end recorded allowable indirect expense rates. These records should be verified during the next scheduled field visit to that contractor. After the final indirect cost submission has been received, the guidance contained in 6-707.3 should be followed.

6-705.2 Adjustment of Interim Indirect Cost Reimbursement

a. After the establishment of final indirect cost rates for the period (see 6-708 and 6-709), the contractor may claim reimbursement for amounts due over and above the interim reimbursements previously obtained. The reimbursement claim should be submitted on separate public vouchers which should not include any other costs or fee. The amount of the adjustment will be shown on the SF 1035

(continuation sheet for the public voucher) in the "current period" column, and the "cumulative to date" figures will be adjusted accordingly. (See DCAAP 7641.58 and 7641.90 for the format to be used on the SF 1035.)

b. Where the contractor submits a correctly computed reimbursement voucher for any additional amounts due under the contract on the basis of the final indirect cost rates established either by negotiation or audit determination, the auditor will be in a position to approve the adjustment voucher as submitted by the contractor. If the contractor does not agree with the established final indirect cost rates and the amounts claimed in its adjustment voucher are in excess of the amounts acceptable to the government, the auditor will then issue a DCAA Form 1 in accordance with the procedures in 6-905, to effect adjustments to amounts acceptable based on the established final indirect cost rates. Where final indirect cost rates are established by negotiation (see 6-703), the DCAA Form 1 will be supported by a copy of the indirect cost rate agreement signed by the contractor and the contracting officer, or by a copy of the contracting officer's unilateral decision where the parties fail to agree (FAR 33.211).

c. If the total interim indirect cost previously claimed for the period exceeds the amount due pursuant to the final indirect cost, the contractor should deduct the excess from the amount otherwise due on a current public voucher under the contract. The deduction must be shown as a separate figure in the "current period" column of the SF 1035. The cumulative figures will be adjusted in the same manner as described above. If the contractor fails to make the adjustment within a reasonable time (usually considered to be 30 days), the auditor will prepare an appropriate DCAA Form 1 to suspend the excess.

6-705.3 Reimbursement of Indirect Costs on Fixed-Price Contracts

As with cost-type contracts, the established billing rates (whether by negotiation or by audit determination) will be used by the contractor in calculating its progress payments. Progress payments,

however, are usually limited to a stated percentage of total cost. On establishment of the final indirect rates, little additional effort is required other than ensuring that the total incurred cost to date and the estimated costs to complete amounts on the next progress payment request have been properly adjusted for any changes in the rates.

6-706 Indirect Cost Certification

6-706.1 Billing or Final Indirect Cost Rates

a. DFARS 242.770-2 requires DoD contractors to certify that all costs included in a proposal to establish billing or final indirect cost rates are allowable in accordance with contract requirements and DoD cost principles. The certification requirement became effective on 12 March 1985 at the initiative of the Secretary of Defense and was subsequently issued in its final form by the Defense Acquisition Regulatory Council on 21 April 1986 with an effective date of 14 April 1986. The DoD Authorization Act of 1986, Public Law 99-145, codified the certification requirement at 10 U.S.C. 2324(h)(1). This certificate must be submitted before the proposal will be accepted by the government. A new certificate is required whenever the contractor changes the proposed rates and submits a revised proposal. A new certificate is not required if the contractor agrees to lower indirect rates as a result of our audit or a previously certified proposal. As a result of the certification process, some contractors have incurred extraordinary costs for screening overhead costs prior to certifying their proposals (see 7-1909.2).

b. Before beginning the audit or proceeding with the settlement of submissions received prior to 12 March 1985, the auditor should determine whether the contractor intends to certify the final costs at settlement. If the contractor intends to certify at settlement, the audit effort may be completed, the exit conference held, and other settlement actions accomplished without the certificate. However, no written rate agreement/understanding should be prepared and executed before receiving a certifi-

cate from the contractor. If an uncertified proposal is accepted in error after 12 March 1985, the auditor should immediately request a certificate from the contractor. If it is determined that the contractor will not certify the final rates, audit or settlement effort should be discontinued and the procedures in 6-706.1c should be followed.

c. If a contractor refuses or otherwise fails to certify its proposal for billing rates, the auditor should promptly notify the ACO. The auditor should request the contractor to confirm its refusal in writing and to explain the reason(s) for refusing to certify. A refusal to certify will be considered an unsatisfactory condition and be reported as prescribed in 4-803.

d. When a contractor does not certify its proposal, DFARS 242.770-4 requires the contracting officer to unilaterally establish the rates. The auditor's role is to provide rate recommendations which preclude reimbursement of potentially unallowable costs. In arriving at his/her rate recommendations, the auditor may use audited historical data, such as percentage disallowance factors computed from the results of prior audits, or any other supporting data obtained from the contractor which show that unallowable costs have been excluded. The scope of audit and the supporting data on which the rate recommendations are based will have to be determined by the auditor on a case-by-case basis. However, the following steps should be considered:

(1) Advise the contractor in writing that its uncertified proposal cannot be used to establish rates, and that a detailed account-by-account analysis is required to be submitted identifying all unallowable costs.

(2) Review historical audited cost to determine if it is representative of allowable cost for the period under review. Give consideration in this assessment to the degree that organizational, procedural, programmatic, or business volume changes may have affected either the incurred expenses, allocation bases, or nature or level of unallowable costs.

(3) If the contractor does not submit the detailed expense account analysis, which identifies all unallowable costs,

and historical audited cost data does not appear to be representative, notify the contracting officer that no audit means exist to advise him/her on what unilateral rates should be established. Provide whatever information you have developed on prior audit history, including why it is not considered representative of allowable cost for the period under review.

(4) In no case should the auditor develop an alternative contractor proposal or complete an audit of the contractor's incurred cost when the contractor has not submitted a properly certified proposal. Either action would relieve the contractor of its contractual requirement to submit a proper proposal that excludes all unallowable cost. As described in 6-706.2 however, certain MAARs can be performed before submission of the certified proposal.

(5) If requested by the contracting officer, prepare an advisory audit report on the auditor's rate recommendations and attach Forms 1 as appropriate. Although the rates for the fiscal year involved may be subject to audit determination, the auditor is not required to enter into the resolution process with the contractor. Upon receipt of the audit report, the contracting officer will issue a unilateral decision. At this point, the contractor may choose to proceed in accordance with the disputes clause.

e. In the event a contractor withdraws or indicates it will withdraw its proposal, consider discontinuing your audit effort, request that the contractor explain why the proposal is being withdrawn, and promptly notify the ACO in writing of the situation. Also, when applicable, advise the ACO that the contractor's proposal was initially submitted late, the withdrawal will delay the audit and settlement of indirect expense rates, and that the withdrawal may result in the loss of "M" account funds. You should seek assistance from the ACO to establish a firm date for the contractor's resubmittal of the proposal. If the contractor refuses to resubmit a certified proposal in a timely manner, the FAO should follow the procedures outlined in 6-706.1c and d. A model pro forma memorandum addressed to the ACO is shown in Figure

6-706.1e.

6-7-1. Modify it as appropriate to suit each situation.

6-706.2 Performance of MAARs Without a Certified Proposal

a. Auditors should exercise their judgment when there is an opportunity to perform certain MAARs and they have not received a certified proposal. Factors that the auditor should consider include:

(1) The MAAR must be performed on a real-time (concurrent) basis before the certified proposal is submitted or the opportunity to perform that MAAR is lost.

(2) MAARs relating to the audit of indirect expenses are generally not performed prior to the receipt of a certified proposal because the contractor usually concentrates on reviewing indirect expense accounts and eliminating unallowable costs prior to certifying the proposal.

(3) The contractor has good internal controls related to the audit area covered by the MAAR and there is very little probability that unallowable costs will be found.

(4) Audit techniques such as multi-year auditing can be used to more efficiently accomplish the MAAR for more than one year in the same audit.

b. Generally, the MAARs that can be performed without a proposal relate to internal control and risk assessment steps, certain reconciliations, concurrent reviews of labor and material costs, requests for assist audits, and tests of adjusting entries. The MAARs that would not normally be performed are the MAARs related to determining the allowability and reasonableness of indirect costs and those reconciliation steps which require a submission.

In most cases, the timing on the accomplishment of the MAARs can be categorized as follows:

(1) Proposal not needed to perform:

MAAR No.

1. Update Internal Control Survey
3. Permanent Files
4. Tax Returns and Financial Statements
5. General Ledger, Trial Balance, Income, and/or Credit Adjustments*

6. Labor Floor Checks or Interviews
7. Changes in Direct/Indirect Charging
8. Comparative Analysis-Sensitive Labor Accounts
9. Payroll/Labor Distribution Reconciliation and Tracing
10. Labor Adjusting Entries and Exception Reports*
11. Purchase Adjusting Entries and Exception Reports*
12. Auditable Subcontracts/Assist Audits
13. Purchases Existence and Consumption
15. Indirect Cost Comparison with Prior Years and Budgets
20. Indirect Adjusting Entries*

*If these MAARs were accomplished before the certified proposal is provided, supplemental audit work would need to be performed after the proposal is received to determine if additional adjusting entries were made during the preparation of the proposal.

(2) Proposal needed to perform:

MAAR No.

2. Contract Cost Analysis and Reconciliation to Books
14. Pools/Bases Reconciliation to Books
16. Indirect Account Analysis
17. IR&D/B&P Compliance
18. Indirect Allocation Bases
19. Indirect Rate Computations

6-706.3 Corporate, Group, or Home Office Expenses

a. The certification requirement is predicated on the idea of a knowledgeable corporate official accepting individual responsibility for the allowability and allocability of costs included in indirect cost proposals. All corporate indirect cost submissions used to allocate costs to divisions for establishment of billing or final overhead rates must be certified at the corporate level. These costs need not be certified again at the division level, and the divisional certification would

only cover indirect costs arising from that division.

b. If a contractor refuses to certify a proposal made at this level, the FAO should follow the procedures outlined in 6-706.1c and d.

6-707 Indirect Cost Audits

6-707.1 Submission of Indirect Cost Proposal

a. The contractor is to submit (within 90 days after the end of the applicable fiscal year) its final indirect cost rate proposal and; if related to DoD, the submission must include an executed Certificate of Indirect Costs (required per DFARS 242.770-2; a copy of the certificate is shown at DFARS 252.242-7001) to the ACO and the auditor. This certificate, signed by no lower than a company vice president or chief financial officer, is required for all final indirect rate submissions, except CAS 414 (cost of money) factors, regardless of whether the rates will be established by auditor determination or contracting officer negotiation. For multidivisional contractors, the proposal for each segment is to be submitted to the divisional ACO and the auditor responsible for conducting audits of that division, with a copy to the corporate auditor and ACO. It is suggested that the contractor be provided a copy of DCAAP 7641.90 and be requested to submit the final indirect cost rate claim in that format to expedite the audit review.

b. The contracting officer is responsible for obtaining interim billing and final indirect rate submissions from the contractor within 90 days after the end of its fiscal year. To assist the contracting officer in this responsibility, it is DCAA policy that the auditor will provide summary status reports on overdue indirect cost submissions to cognizant ACOs every 31 January and 31 July. If the auditor receives a submission from either the contractor or contracting officer that is inadequate for audit, the auditor should inform the contracting officer of his/her concerns. The auditor should seek agreement with the contracting officer as to an appropriate course of action, which may include requesting additional informa-

tion from the contractor or returning (rejecting) the submission as inadequate for audit.

6-707.2 Requests for Audit

a. When the submission is received and the indirect cost rates are based on audit determination, necessary actions are taken to review and finalize the billing/final rates without need for a request for audit.

b. If the rates are based on contracting officer negotiations, advisory indirect cost audits should be conducted on request or under a standing arrangement with the office responsible for issuing a request. The purpose for which the indirect cost report will be used should be clearly understood and delineated in the request or record of the standing arrangement. When requests reasonably can be anticipated, arrangements should be worked out with the contracting officers, or others responsible for the requests, for the advance submission of data that would assist in the timely performance of the audit.

c. All audit requests of indirect cost submissions should be promptly acknowledged in writing. This acknowledgment should include the anticipated audit report date. The processing of non-DoD Agency audit requests is discussed in 1-303.

d. Advisory indirect cost audits should be initiated without request whenever it is in the best interest of the government.

6-707.3 Timeliness of Final Indirect Cost Audits

It is DCAA policy that all indirect cost submissions will be reviewed as promptly as practical after receipt of the contractor's proposal. When an audit cannot be performed within a reasonable period, care must be taken to minimize the impact on the contractor's cash flow. If there is a significant disparity between billing and actual rates, the contractor should be advised to either submit an interim claim for the difference if the billing rate is lower, or to remit or otherwise credit the government for the difference if the actual rate is lower. The amount of the claim or credit should include a reasonable estimate for anticipated audit adjustments.

6-707.4**6-707.4 Audit Objectives and Procedures**

a. This section provides the administrative procedures that should be used in establishing billing and final indirect cost rates. Section 6 of this chapter states the audit procedures to be considered in the examination of indirect expenses incurred and claimed in the performance of contracts. Chapter 9 sets forth the procedures for the evaluation of indirect expenses included in price proposals. The procedures and objectives in these chapters should be applied as appropriate when performing the indirect cost audit.

b. The cost principles in FAR Part 31 should be used as the basis for determining the allowability, allocability, and reasonableness of indirect expenses in billing/final indirect cost rates whether these rates are negotiated by the contracting officer or determined by audit. These same cost principles, as appropriate, should be considered in the evaluation of indirect expenses included in cost proposals used for the negotiation and award of contracts, or amendments to existing contracts.

6-708 Establishment of Final Indirect Cost Rates by Audit Determination

a. When the FAR provides for audit determination of final indirect cost rates, the contractor, after the close of its fiscal year, will furnish the contracting officer and auditor with a copy of its final indirect cost rate proposal for the period (see 6-707.1). Auditors will encourage contractors to submit their proposals as promptly as possible after the close of the fiscal year. The auditor will promptly perform an audit and will issue an incurred cost audit report (per 10-500) to the cognizant ACO.

b. During the course of the audit, significant audit findings should be brought to the attention of, and discussed with, the contractor, and when appropriate with the cognizant principal ACO and CAC, as soon as possible so as to expedite the resolution process (See 6-902e). The discussions are to ensure that the auditor's conclusions are based on a proper understanding of the facts and to ascertain whether the contractor/ACO/CAC

has any additional information which would support or modify the audit findings. Significant procedural and control deficiencies, or CAS/FAR noncompliance, should be reported immediately using the procedures in 10-400 or 10-800. When a Form 1 is appropriate, it should be issued immediately in accordance with procedures in 6-900 (See 6-708.1g). If the auditor believes that the billing rate should be adjusted, an appropriate recommendation (including cost impact calculations) should be made to the contracting officer. When there are no findings which require an immediate report or Form 1, individual workpackages which are part of the final overhead audit may be closed using a "MEMORANDUM FOR RECORD" (See 10-202). See 15-100 for additional comments related to non-DoD agencies.

6-708.1 Actions Taken at Completion of the Audit

a. Upon completion of the audit field work necessary to review local costs (including assist audits other than corporate or home office reviews), the auditor will hold an interim exit conference. At that time the auditor will provide the contractor with the results of the audit in writing and seek the contractor's agreement. These results will be presented in such a manner that the contractor will clearly understand the reasons for disapproving the costs and the basis for any additional audit recommendations. However, the contractor's required resolution period, as discussed below, does not start until all assist audits are complete, and the final results of audit are presented to the contractor in a final exit conference.

b. Upon presentation of the final audit results in written form, the contractor then has 60 days to provide its agreement or submit rebuttal comments (a 30 day extension may be granted by the auditor based on written request from the contractor giving the reasons for the extension). If the contractor requests fact-finding sessions, it is acceptable for the auditor to participate in discussions with the contractor to clarify factual matters. However, the auditor has not been delegated the authority to "negotiate" final indirect cost rates. The auditor's respon-

sibility is to determine the final indirect cost rates based on audit of the contractor's records, applicable government regulations, and contract terms.

c. For multidivisional contractors, the auditor responsible for conducting the audit is responsible for seeking agreement with that contractor. The corporate home office auditor (CHOA) or contract audit coordinator (CAC) is responsible for seeking agreement with the contractor on corporate home office costs. The CAC network shall be used to the fullest extent to ensure uniformity and consistency in arriving at audit recommendations. At a minimum, the divisional auditor shall provide a copy of the audit results to the CAC prior to discussions with the contractor.

d. Upon receipt of the contractor's rebuttal comments, the auditor will have 60 days to thoroughly analyze the contractor's response, notify the contractor of any changes to the audit exceptions, and issue the audit report (see 6-708.2). If changes are made, the reasons for all changes will be thoroughly documented in the working papers. After the auditor has completed reviewing the additional data and making any necessary changes, a final meeting shall be scheduled to advise the contractor of any changes to the original audit recommendations. During this meeting, the auditor should seek the contractor's agreement on any remaining areas of difference. The ACO will not ordinarily attend any of the audit determination meetings with the contractor; however, the auditor should keep the ACO informed of developing areas of disagreement which may lead to a DCAA Form 1. This need for communication becomes even more imperative at contractor locations where responsibilities for establishing final rates and authority for negotiating forward pricing rate agreements (FPRAs—an ACO responsibility) with the contractor are divided between the auditor and the ACO.

e. An audit report cannot be issued until the audit is considered complete. An audit is not complete until the results of all assist audits, such as corporate home office allocations, subcontract audits, Washington office audits, Field Detachment input, etc. are incorporated. As

a result, reports on audit-determined final indirect cost rates should not contain qualified opinions or unresolved costs related to assist audits. Should the requesting auditor encounter protracted delays in obtaining assist audit results and be unable to reach a resolution, the situation should be elevated to the region for resolution. Indirect cost rates should not remain open awaiting the resolution of BCA cases, technical problems, and other items beyond DCAA's control. These items will not delay issuing the audit report. The report should be issued with appropriate qualifications and be supplemented later as necessary.

f. Settlement of the indirect rates may be delayed because of unresolved CAS noncompliances. When an initial determination of noncompliance is in effect, the CAS administration procedures should be allowed to proceed. The issuance of an audit determined indirect rate report or a DCAA Form 1 should be deferred to the extent practicable until a final determination on the CAS noncompliance is made. Extended delays should be escalated in a manner similar to that specified in CAM 4-803.4. If delays are not resolved, the report should be issued including the effects of the initial finding of noncompliance and the report qualified if the ACO's final determination could materially impact the audit determined rates. Where a final determination of noncompliance has been issued, the audit determined indirect rate report should include the effects of the CAS noncompliance.

g. Although the audit report cannot be issued until all required audit work has been completed, the issuance of a Form 1 should not be delayed until the audit report is issued. If the contractor does not agree with the disapproved costs, the auditor may prepare and issue a Form 1 at that point even though the final report is not due to be issued until other items are completed. (Also see 6-708.3 and 6-900 for further comments on issuance of Forms 1.)

h. Should the contractor fail to provide its agreement or rebuttal comments within the time period allotted (including the 30-day extension if granted by the auditor), the audit report shall be issued

¶6-708.1h.

together with applicable DCAA Forms 1. The working papers and audit report should state that the contractor failed to comply with the time requirement.

6-708.2 Actions Taken if Agreement is Reached

a. If agreement is reached, the auditor will prepare a written rate agreement/understanding setting forth the final indirect cost rates. This document will automatically be incorporated into the contracts upon execution as provided by the Allowable Cost and Payment clause.

b. Guidelines for the content of the written understanding are contained in FAR 52.216-7(d)(3). A pro forma rate agreement is included as 6-7S1. The contractor should be given a maximum of 10 days to sign and return the agreement to the auditor. This is because the final meeting (per above requirements) and the 10-day period for the contractor to sign the written agreement shall be scheduled to allow the audit report to be issued within 60 days from the date the auditor received the contractor's rebuttal comments. A copy of the signed rate agreement shall be attached to the final audit report.

c. Where practicable, the rate agreement should include a schedule showing the allowable costs by contract (see 10-505). This will facilitate both the contractor's preparation of closing documents and the auditor's preparation of contract audit closing statements. If not practical (e.g., if the schedule would be too voluminous), refer to the specific records that detail the allowable costs by contract and subcontract.

6-708.3 Actions Taken if Agreement is Not Reached

a. If agreement is not reached, the auditor will issue notices of costs suspended and/or disapproved (DCAA Form 1 or equivalent non-DoD forms, where applicable). These notices will detail the items of difference and advise the contractor of its right to (1) request in writing the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss his or her findings with the contractor or (2)

submit a claim to the ACO for any disapproved costs. Under this procedure, the contracting officer does not negotiate final indirect rates, but issues written determinations or final decisions on specific issues with which the auditor and the contractor do not agree. Accordingly, it is extremely important that the applicable DCAA Form 1 be prepared so the contracting officer is able to obtain a thorough understanding of the issues involved (see 6-900). The Forms 1 issued shall accompany the audit report as prescribed in 10-503d and should be cross-referenced. However, both the Form 1 and the audit report should contain sufficient detailed explanations so that each can stand alone.

b. If the inclusion of initial findings of CAS noncompliances prevents agreement of final indirect rates, the audit report should be forwarded to the ACO for resolution in accordance with FAR 42.705-2(b)(2)(v). If the contractor appeals the final determination of noncompliance under the Disputes clause, the resolution of the CAS noncompliance is now subject to litigation and beyond DCAA's control. In this instance, the audit determined indirect rate report should include the effects of the unresolved CAS noncompliance.

6-708.4 Reporting Audit Results

Regardless of the outcome of the determination process, an audit report shall be submitted to the ACO. Prepare and distribute the formal audit report on the audit-determined rates as described in 10-500. Any necessary DCAA Forms 1 should be attached to the report. Once the report is issued, the contractor may request ACO reconsideration or file a claim for the disapproved costs as explained in 6-908.

6-709 Establishment of Final Indirect Cost Rates by Contracting Officer Negotiation

a. Where FAR provides for contracting officer-negotiated final indirect cost rates (other than predetermined rates), the contractor, after the close of its fiscal year, will furnish the contracting officer

and auditor with a copy of its final indirect cost rate proposal for the period (See 6-707.1). Auditors will encourage contractors to submit their proposals as promptly as possible after the close of the fiscal year. The auditor will promptly perform an audit and will issue an advisory incurred cost audit report (per 10-500) to the cognizant negotiating contracting officer for use in the rate negotiations.

b. During the course of the audit, significant audit findings should be brought to the attention of, and discussed with, the contractor, and, where appropriate, with the principal cognizant ACO and CAC as soon as possible so as to expedite the resolution process (See 6-902e). The discussions are to ensure that the auditor's conclusions are based on a proper understanding of the facts and to ascertain whether the contractor/ACO/CAC has any additional information which would support or modify the audit findings. Significant procedural and control deficiencies, or CAS/FAR noncompliance should be reported immediately using the procedures in 10-400 or 10-800. When a Form 1 is appropriate, it should be issued immediately in accordance with procedures in 6-900. If the auditor believes that the billing rate should be adjusted, an appropriate recommendation (including cost impact calculations) should be made to the contracting officer. The contracting officer should immediately forward these findings to the contractor with a request to respond within 60 days (one 30-day extension may be granted). When there are no findings which require an immediate report or Form 1, individual workpackages which are part of the final overhead audit may be closed using a "MEMORANDUM FOR RECORD" (See 10-202). See 15-100 for additional comments related to non-DoD agencies.

6-709.1 Actions Taken at Completion of the Audit

a. Upon completion of the audit field work necessary to review local costs (including assist audits other than corporate or home office reviews), the auditor will hold an exit conference. The contracting officer will be given an advance briefing

on the audit findings and invited to attend. The auditor will provide the contractor with a written summary of the audit results at the exit conference. The summary must clearly state the reasons for questioning the costs and the bases for any additional audit recommendations.

b. The contracting officer should request the contractor to respond to all findings within 60 days (one 30 day extension may be granted). Contracting officer concurrence is not a precondition to holding the exit conference. However, the contracting officer should understand the findings and participate in the resolution process.

c. Should the contractor fail to provide its agreement or rebuttal comments within the time period allotted (including the 30-day extension if granted by the contracting officer), the auditor will promptly issue the audit report. The working papers and audit report should state that the contractor failed to comply with the time requirement.

6-709.2 Reporting Audit Results

a. Upon receipt of the contractor's rebuttal, the auditor will have 60 days to seek contractor concurrence, and issue the final audit report. In order to provide the ACO as much assistance as possible in deciding open issues, the auditor should logically and fairly address the contractor's rebuttal to the audit position. If the auditor is unable to present a strong, logical defense to the contractor's rebuttal he/she should consider withdrawing the finding. Each open issue in which there is not concurrence should be presented in the audit report in the following format:

(1) A clear, concise description of the audit finding as required by 2-404.

(2) The contractor's rebuttal should be summarized immediately following the description of the audit finding and attached in its entirety as an enclosure to the audit report.

(3) The auditor's rejoinder to the contractor's rebuttal should defend the audit position in light of the contractor's comments and fully explain in logical terms why the contractor's argument is flawed or otherwise inappropriate. If the auditor

16-709.2a.

has modified the finding as a result of considering the contractor's comments, this fact should be disclosed.

b. When assist audits are required, the requesting auditor will coordinate with the assist auditor when establishing due date requirements. The assist auditor should make every effort to complete the audit within the time frame established. Should the requesting auditor encounter protracted delays in obtaining assist audit results and is unable to reach a resolution, the situation should be elevated to the region for resolution. An audit report may be issued before completion of assist audits on corporate or home office costs. The report should show the corporate or home office costs as being unresolved, and upon receipt of the assist audit reports, a supplemental audit report should be issued if requested by the contracting officer.

c. A qualified report may also be issued before completion of the assist audits of the subcontract or intercompany costs if the following conditions are met:

- The annual assist audit has been requested and the report is expected to be received before the planned date of the final audit on the contract (see 6-802.4a on subcontract assist audit requests). The requesting audit office should have a system to monitor receipt of subcontract assist audit reports, follow-up on those audits not promptly received, reconcile subcontractor costs included in the assist audit report with those included in the upper tier contractor incurred cost submission, and issue any needed supplemental audit reports.
- There are no known audit leads or significant risks relating to the subcontractor's accounting or billing systems.
- The upper tier contractor has adequate internal controls relating to subcontract costs.
- The subcontract and intercompany costs do not have a material impact on the indirect cost allocation basis.

See 10-504.2 for the information needed to be included when the audit report is qualified for nonreceipt of assist audit reports.

d. After the audit report is issued the contracting officer will attempt to reach a settlement with the contractor within 60 days. If settlement is not reached within this period, the contracting officer should issue a final decision on any open items within 30 days. The auditor should be invited to attend all meetings between the contracting officer and contractor during which open items are formally discussed. Forms 1 will be issued with the audit report only when requested by the contracting officer (See 6-900).

6-710 Indirect Costs and Advance Agreements

a. The contracting officer may enter into advance agreements with the contractor concerning the allowability of special cost elements, ceilings for IR&D/B&P, etc. The auditor shall abide by properly executed advance agreements that are in effect for the fiscal year when determining final rates. Should the auditor find that an advance agreement is not in the best interest of the government, he/she will follow established procedures for recommending to the contracting officer, in writing, that the advance agreement be rescinded. Any steps taken to recommend rescinding the advance agreement will be thoroughly documented in the working papers.

b. A recommendation to rescind the advance agreement should not unduly delay issuing the audit report. If the ACO does not provide a timely response, the auditor will proceed with the formal exit conference and present the audit results to the contractor. The audit recommendations will incorporate the terms of the advance agreement. The report exhibit(s) will indicate that the auditor relied on the terms of the advance agreement. The circumstances involving the advance agreement, including the auditor's actions with respect to the advance agreement, shall be included in Appendix 2 of the audit report as provided in 10-506.2.

6-711 Expediting Establishment of Indirect Costs

6-711.1 Expediting Settlement of Indirect Costs on Completed Contracts

a. The final period of performance under a contract is generally less than a

full fiscal year, and some contracts will in fact, be completed early in the year. The indirect cost rate determination for the contractor's fiscal year in which a contract is physically completed may not occur for a considerable period of time thereafter, since the contractor's indirect cost proposal may not be submitted up until three months after the end of its fiscal year. It is recognized, therefore, that in many cases the expeditious settlement of indirect costs and the prompt close out of physically completed contracts have considerable administrative advantage to both the government and the contractor.

b. Accordingly, FAR 42.708 provides for quick-closeout procedures. These procedures allow the contracting officer to negotiate a settlement of indirect costs for a specific contract, in advance of the determination of final indirect rates. Use of the quick-closeout procedures for a specific contract will be binding on that contract and no adjustment will be made to other contracts for the over- or under-recovery of costs that may result from the agreement. Likewise, using the quick-closeout procedures will not be considered as a precedent when establishing final indirect rates for other contracts.

c. Use of these closeout procedures is discretionary. The auditor should, therefore, obtain the approval of the cognizant negotiating contracting officer before applying these procedures to an individual contractor. The contracting officer will normally approve their use since it is the government's policy to encourage con-

tractors to close completed contracts promptly. (See 6-1009 for further on use of quick-closeout procedures.)

d. Where a cost reimbursement type contract is to be so closed, an agreement should be reached by the contractor, the auditor, and the contracting officer as to the indirect cost to be allocated for the final period. Audit guidance for the allocation of indirect cost in these situations is stated in 6-605c. The agreement should be reached prior to contractor's submission of its final voucher so that this voucher can be processed without requiring any further adjustment.

6-711.2 Expediting Settlement of Indirect Costs on Terminated Contracts

As discussed in 12-407, settlement of a terminated contract may be unduly delayed if settlement is held until final indirect rates are established. Accordingly, FAR 49.303-3 permits negotiation or use of the billing rates as final rates to expedite closing a terminated contract. Aside from ensuring that allocated indirect costs to the terminated contract are reasonable (12-304.15), the other main concern when using this closeout procedure is to ensure that the subsequent final rate proposal is consistent with the amounts used to closeout the terminated contract (e.g., items included as settlement expenses which would normally be part of indirect costs, like salaries related to preparing the settlement proposal, are eliminated from the proposed indirect cost pools).

6100
6-7S1

January 1995

**6-7S1 Supplement—PRO FORMA FINAL INDIRECT COST
RATE AGREEMENT**

XYZ Company, ABC Division
1985 Main Street
Any City, State 00000

Gentlemen:

This letter sets forth the agreed upon final indirect cost rates established by audit determination in accordance with DAR 3-705(c)(iv) (FAR 42.705-2(b)(2)(iii) and DoD FAR Supplement 242.705-2(b)(2)(iii)).

The final annual indirect cost rates for fiscal year ended 31 December 1986 are as follows:

Cost Center	Rate	Allocation Base	
		Amount	Description
Material Burden	5.5%	\$2,569,400	(a)
Manufacturing Overhead	146.4	5,156,300	(b)
Engineering Liaison	95.2	1,207,900	(c)
G&A Expense	12.1	18,056,300	(d)

(a) Total direct manufacturing costs, exclusive of materials drop shipped to offsite locations.

(b) Total direct manufacturing labor dollars exclusive of overtime premium pay.

(c) Total direct engineering labor dollars.

(d) Total incurred cost exclusive of G&A expense.

These rates are applicable to the base costs specified for each of the contracts performed during your fiscal year ended 31 December 1986. The indirect costs and allocation base by contract for the indicated fiscal year are shown in Attachment 1.

This indirect rate understanding shall not change any monetary ceiling, contract obligation, or specific cost allowance or disallowance provided for in the contracts listed in Attachment 1. This understanding is incorporated into each of the affected contracts upon execution.

Specific indirect cost items treated as direct costs in the settlement of the subject rates are discussed in Attachment 2. (The subject rates do not include any specific indirect cost items which were treated as direct costs in the settlement of the subject rates.) Contracts containing advance agreements or special provisions rendering these rates inapplicable, in part or whole are identified in Attachment 3, with the applicable special rate(s) noted.

Please confirm your acceptance of the terms of this indirect cost rate agreement by signing and returning this letter to me. A duplicate of this letter is enclosed for your records.

You are directed to promptly submit adjustment vouchers or final vouchers for all flexibly priced contracts. Audit adjustments should be clearly delineated so as to be readily identifiable for verification by this office. Care should be taken that amounts claimed do not exceed contract limitations or contract indirect cost rate ceilings.

Sincerely,

Encls

Attachment 1—Schedule of Allowable Cost by Contract

Attachment 2—Schedule of Specific Indirect Cost Items Treated as Direct in the Settlement of CFY 1986 Rates

Attachment 3—Schedule of Special Indirect Cost Rates for Contracts Containing Advance Agreements or Special Provisions

The XYZ Company accepts the above stated final indirect cost rates.

NAME James E. Contractor

SIGNATURE _____

TITLE Vice President

DATE _____

CONTRACTOR XYZ COMPANY, ABC DIVISION

January 1995

6101
Figure 6-7-1

Figure 6-7-1

NOTIFICATION MEMORANDUM TO ACO

[Date]

MEMORANDUM FOR THE ADMINISTRATIVE CONTRACTING OFFICER,
[insert the cognizant ACO organization]

Attention: Mr./Ms. _____

Subject: Contractor Withdrawal of Indirect Expense Rate
Proposal for FY 19xx, [insert the contractor name]

We are in the process of reviewing [or plan to review] the [insert the contractor name]'s final indirect expense rate proposal for FY 19xx. On [day/month 19xx] the contractor notified our office that the submission for FY 19xx is being withdrawn. [Describe the reasons for contractor withdrawal; e.g., We understand the contractor's withdrawal is due to recent stories in the press regarding possible changes to the current law on penalties for unallowable costs.] As you know the FY 19xx claim was already submitted _____ months late based on contract requirements.

We are concerned that the contractor's withdrawal of the indirect expense rate proposal(s) is unduly delaying the settlement of rates and could have adverse funding consequences. If contracts cannot be closed before cancelation of the appropriations under the terms of the FY 1991 Authorization Act amendment on "M" accounts, any subsequent payments would have to be made with current year funds.

Your assistance is requested to establish a firm date for the contractor's resubmittal of the proposal(s). This will enable us to plan to have the necessary audit staffing in place to complete the audit(s) as expeditiously as possible. If the contractor is not responsive, we would encourage consideration of the available remedies including unilaterally established rates (DFARS 252.242-7001).

We appreciate your continued support of our joint objective to reduce the incurred cost audit backlog. If you would like to discuss this matter further, please contact Mr./Ms. _____, Supervisory Auditor, at [insert the telephone number] at your convenience.

John A. Smith
FAO Manager

6102
6-800

January 1995

6-800 Section 8 — Assist Audits of Incurred Costs

6-801 Introduction

This section presents audit policy for the performance of assist audits of incurred costs on subcontracts, interplant billings, home office expenses, and at offsite locations. For purposes of this section, assist audits refer to the situation where a contract auditor at one location is furnished assistance by a contract auditor at another location.

6-801.1 Basic Responsibilities

a. The prime contractor is primarily responsible for subcontract award, performance monitoring, and payment to the subcontractor for the work accomplished under subcontract terms. To accomplish this responsibility, the prime contractor should have adequate internal controls to identify and notify the government of auditable type subcontracts and intercompany orders under auditable type government contracts and to assure that subcontract/intercompany costs are audited.

b. The contractor's notification to the government should be made upon award of the subcontract and intercompany order and as part of the prime contractor's annual incurred cost proposal. The contractor's notification should include audit planning information such as the subcontract/intercompany order number, subcontractor/intercompany name, and subcontract/intercompany billed and booked costs for the year.

c. The contractor's internal control system over subcontracts and intercompany orders should also provide for including appropriate flow down clauses into the subcontract/intercompany order, such as: clauses that (1) provide either the government or the contractor access to the subcontractor's/intercompany books and records for the purposes of performing the annual incurred cost audit, (2) require billed costs to be allowable pursuant to FAR 52.216-7, and (3) require the subcontractor/intercompany entity to submit annual incurred cost proposals pursuant to FAR 42.7. If the contractor does not have adequate controls over its

subcontracts/intercompany orders, an internal control deficiency report should be issued (see 5-111c.)

d. DCAA policy is to review auditable subcontracts and intercompany orders issued by the contractor under auditable government contracts and subcontracts, and to request or perform assist audits of incurred costs whenever such audits are of potential benefit to the government and necessary to assure adequate and effective review of a contractor's operations or cost representations. Assist audits of incurred costs can be used to satisfy mandatory annual audit requirements related to auditable subcontracts/assist audits (MAAR 12).

e. Under certain conditions, it is desirable that DCAA audit the subcontractor. Examples of these conditions are (1) the subcontract dollar value is significant in amount and in relation to the prime contract dollar value, (2) a subcontractor objects to an upper-tier contractor auditing its records for competitive reasons, (3) a DCAA auditor is currently performing audit work at the subcontractor's plant or can perform the audit more economically or efficiently, (4) DCAA audit is necessary for consistent audit treatment and orderly administration, or (5) the contractor or subcontractor has a substantial or controlling financial interest in the other.

f. In determining whether the government should examine a subcontractor's records, the auditor should consider the potential benefits to the government from the audit, previous audit experience and results at the subcontractor, and the costs of performing the audit. An audit will be conducted whenever the Plant Representative/ACO or the auditor determines an assist audit is necessary.

g. The government's interest and good auditing practice require that assist audits of incurred costs be accomplished primarily while the contract is physically being performed.

h. Requests for assist audits of incurred costs will be processed through audit channels (6-802.4) and documented in

the FAO control system to provide visibility of assist audits in process.

i. The auditor should coordinate the assist audit plans with the upper tier contractor to preclude duplicate audits and provide for contractor audits if DCAA does not plan on performing the assist audit.

j. Mandatory annual audit requirements related to auditable subcontracts/assist audits (MAAR 12) is satisfied at the higher-tier location by requesting, analyzing, and incorporating the subcontract assist audit into the final audit report. The assist auditor should make every effort to issue the assist report in time for incorporation into the upper tier auditor's incurred cost report. However, a qualified incurred cost report may be issued before receipt of the assist audit on subcontract and intercompany costs if the criteria described in 6-709.2c are met.

6-801.2 Special Considerations - Release of Subcontractor Data to the Higher-Tier Contractor

When a DCAA subcontract assist audit is contemplated, the higher-tier contractor normally will have made satisfactory arrangements for its unrestricted access to the subcontract audit results so that it will be able to fulfill its responsibilities for settling any audit exceptions. In rare cases, this may be impracticable. The following procedures are required to protect subcontractor data when special circumstances warrant such protection.

a. Before beginning a subcontract audit, determine whether the subcontractor will have any restrictions or reservations on release of the resulting audit report(s) to the higher-tier contractor. A significant reservation exists if the subcontractor desires to withhold its decision on release of an audit report pending review of the audit results or report contents. If the subcontractor does not assure unrestricted report release at the outset, refer the matter to the requesting higher-tier contractor auditor. The latter will reassess the assist audit request, consulting with the higher-tier contractor and/or Plant Representative/ACO as appropriate.

b. In most cases, the higher-tier contractor should be able to remove the subcontractor's objections to unrestricted

release of the audit results. This may be necessary to avoid government suspensions or disapprovals of subcontract costs billed by the higher-tier contract. If the prime contractor's diligent efforts are unsuccessful, request the Plant Representative/ACO to advise whether the subcontract costs should be audited by the government even though some or all of the audit report information may have to be kept within government channels.

c. There may be rare cases when the higher-tier contract auditor and Plant Representative/ACO decide that an audit should proceed without the subcontractor's advance concurrence on report release. In such cases, the subcontract auditor should attempt during the exit conference to obtain the subcontractor's concurrence in unrestricted release of the report to the higher-tier contractor. If this fails, the subcontract auditor should modify the audit report cover sheet per 10-206.3. If practicable, obtain the subcontractor's written statement as to what information may be released, and provide this to the report addressee either as a report appendix or by separate correspondence.

d. At subcontractor locations where recurring cost audits are made on subcontracts issued by the same higher-tier contractor, try to expedite the process by developing a working arrangement for unrestricted audit report release. The subcontractor's representative should document the arrangement, with a copy to the auditor.

6-802 Subcontract Incurred Costs

6-802.1 Definitions

a. For the purpose of this paragraph, the term "subcontract" means an auditable subcontract, purchase order, or other form of agreement under which materials or services are to be furnished on a flexibly priced basis to a prime contractor under a flexibly priced contract subject to DCAA audit. Flexibly priced contracts include all cost-type, fixed-price-incentive, and fixed-price-redeterminable contracts, and portions of time-and-material and labor-hour contracts.

76-802.1b.

b. The terms "prime contractor" and "subcontractor" as used in this section also relate to a higher-tier subcontractor and the next lower-tier subcontractor, respectively.

6-802.2 Preparation of Subcontractor's Cost Submission

a. A subcontractor generally submits its costs on commercial invoices directly to the prime contractor. In cases where DCAA will perform the audit, the auditor cognizant of the subcontractor will arrange with the subcontractor to make available file copies of invoices submitted to the prime contractor.

b. The subcontractor should prepare its invoices and incurred cost submission in the same detail and manner as required of the prime contractor.

6-802.3 Prime Contractor Audits of Subcontractors' Claims

As discussed in 6-801, the auditor will often times perform the assist audit of the subcontract costs. The auditor will advise the prime contractor of its assist audit plans to avoid duplicative audits. On those low risk subcontracts where the prime contractor performs the audit, the auditor will review the adequacy of the contractor's work. In those instances, the DCAA auditor shall review the prime contractor's audit working papers to ascertain whether the scope and extent of audit was sufficient to establish the validity of the subcontractor's claims, and that appropriate deductions were made in the prime contractor's claims to the government for unallowable or unallocable subcontract costs. If the DCAA auditor considers the audit to be deficient or inconclusive and believes there is a need for further review of subcontract costs, the prime auditor should discuss the matter with both the contractor and the Plant Representative/ACO to determine if it is feasible for the contractor to correct the deficiencies or if a government audit is necessary.

6-802.4 DCAA Audit of Subcontractors' Costs

a. The DCAA auditor cognizant of the prime contractor or higher-tier subcontractor will initiate timely requests for

assists audits of subcontract incurred costs. Upon notification of a subcontract award, the prime auditor will notify the subcontract auditor of the award and that assist audits will be required. This procedure will facilitate the performance of any time sensitive audit procedures by the assist auditor (e.g., MAARs 6 and 13.) However, the DCAA auditor cognizant of the subcontractor or lower-tier subcontractor has a mutual responsibility to assure concurrent and coordinated audit effort. The prime auditor's timely notification of awarded subcontracts or information as to anticipated subcontract volume to the subcontract auditor is essential to sound audit planning and performance of the assist audits. Both prime and subcontract auditors should maintain adequate controls for identifying auditable subcontracts. These responsibilities include satisfying applicable portions of the mandatory annual audit requirement related to auditable subcontracts/assist audits (MAAR 12).

b. As part of the annual incurred cost audit, the prime auditor will request needed annual audits of proposed subcontract costs. These requests are made on an annual basis during subcontract performance and are in addition to the initial notification to the subcontract auditor of the subcontract award. The amount of detail included with assist audit requests will vary according to the respective audit offices involved, but should normally include copies of the related subcontracts and billing documents showing the billed costs for the period to help the assist auditor identify the costs to be audited. Any potential access to record problems at the subcontractor location should be elevated quickly to the prime auditor and the Plant Representative/ACO (see 1-504.)

c. Some flexibly priced contracts, such as price redeterminable and incentive types, require the submission of price adjustment proposals after completion of a portion or all of the contract. Process requests for reviews of these proposals under the field pricing support procedures of FAR 15.805-5 (i.e., through Plant Representative/ACO channels).

d. The prime and subcontract auditor should coordinate planned audit effort.

The subcontract auditor should discuss the plans with the subcontract Plant Representative/ACO to assure coverage in specific areas of mutual interest. Depending on the materiality of the subcontract and the strengths of the prime contractor's subcontract cost internal control system, the assist audit request can range from a full scope audit to an agreed-upon procedures review encompassing verification of indirect expense rates and direct costs. Based on this coordination, the subcontract auditor will furnish the requesting auditor with the anticipated issuance date of the assist audit report. The requesting auditor will also coordinate these matters with the Plant Representative/ACO at his location.

e. The subcontract auditor will arrange for necessary technical assistance with the subcontract Plant Representative/ACO. Guidance on requesting and evaluating technical assistance is in Appendix D.

f. Although subcontractor invoices will not be audited on an individual billing basis, the subcontract auditor will immediately notify the prime auditor of any major cost items which should be suspended or disapproved or of any financial matters adversely affecting subcontract performance.

g. Upon receipt of advice of a suspension or a disapproval of a subcontract cost, the prime auditor will immediately discuss the matter with the prime contractor's designated representative. The purpose of this discussion is to alert the prime contractor to the need for reaching an agreement with the subcontractor regarding disapproval or suspension of the questioned costs, or recoupment thereof if already paid. On cost-type prime contracts, the prime auditor will also prepare a DCAA Form 1 to effect the necessary deduction from the prime contractor's reimbursement claims. On flexible fixed price contracts, the prime auditor will notify the Plant Representative/ACO by letter of the need to suspend the subcontract costs on progress payment requests (see 14-200).

h. Since the government has no contractual relationship with subcontractors, it is not bound by any agreement between

prime and subcontractors as to payment or disposition of any subcontract costs determined to be unallowable by the DCAA auditor. Therefore, the cognizant auditor will disapprove any such amounts that may be included in the prime contractor's claims under flexibly priced contracts, regardless of the prime contractor's disposition thereof with the subcontractor.

6-803 Interplant Billings

As used in this section, interplant billings are invoices (or credit memorandums) for work or services performed at a contractor's plant or division and charged to flexibly priced contracts at another plant or division. For purposes of this section, the auditor at the plant or division billed for services is referred to as the prime auditor and the auditor at the location where the work is performed is referred to as the lower-tier auditor.

6-803.1 General

a. A contractor may use more than one of its plants or divisions to perform required work or services. It may issue interplant work orders, purchase orders, or requisitions for the services or work to be performed. Where plants or divisions involved are separate entities for accounting purposes, the contractor generally will use interplant billings or invoices to bill costs or charges applicable to the work or services performed. Except as provided in FAR 31.205-26(e), the allowable costs for such work or services will be the actual costs of the performing organizational unit (6-313).

b. The provisions of this section are not applicable to monthly or periodic billings which cover solely estimated indirect expense allocations, such as distributions of home office expenses to various benefiting plants. Ordinarily, the contractor will adjust these allocations to actual at its fiscal year end. The cognizant auditor will review charges of this nature as part of the normal overhead audit at the benefiting plants through the assist audit procedures (6-804).

6-803.2 Audit Procedures

a. The prime auditor will initiate requests for assist audits of interplant billings pursuant to the criteria stated in 6-306.3b.(2) and 6-313 and should normally include copies of the related work orders, purchase orders, or subcontracts and billing documents to help the lower-tier auditor identify the costs to be audited. However, the lower-tier auditor has a mutual responsibility to assure concurrent and coordinated audit effort similar to that envisioned in subcontract audits (6-802). In addition, these responsibilities include satisfying applicable portions of the mandatory annual audit requirement related to auditable subcontracts/assist audits (MAAR 12). The prime auditor's timely identification of auditable interplant work authorizations and information as to anticipated volume of auditable work is essential to sound audit planning and performance of the assist audits.

b. The lower-tier auditor should coordinate planned audit effort with the prime auditor and the lower-tier Plant Representative/ACO to assure coverage in specific areas of mutual interest. Based on this coordination, the lower-tier auditor will furnish the prime auditor with the anticipated issuance date of the assist audit report. The prime auditor will also coordinate these matters with the Plant Representative/ACO at his or her location.

c. The lower-tier auditor will arrange for necessary technical assistance with the lower-tier Plant Representative/ACO. Guidance on technical assistance is in Appendix D.

d. Requirements in 6-1005b. will govern the scope of the incurred interplant costs audit. The audit will normally be comprehensive and include a reconciliation of the cost records to the total interplant billings for each fiscal year during the contract performance. Do not perform audits of individual interplant billings except in unusual circumstances as required by 6-1003f.

6-803.3 Audit Reports

a. The lower-tier auditor will issue timely audit reports, prepared under the

general requirements of Chapter 10, to the prime auditor according to the reporting schedule. The report will cover the acceptability of the total transferred costs, together with specific comments on the indirect expense rates. When circumstances warrant, the lower-tier auditor should issue a special report to advise the prime auditor on a timely basis of newly noted matters which affect the allowability or allocability of interplant costs.

b. Comments on indirect expense rates should indicate whether or not final rates have been established. If final indirect expense rates have not been established, the lower-tier auditor will provide comments regarding claimed billing rates and the effect of questioned costs on the billing rates. The lower-tier auditor will issue a supplemental audit report when indirect expense rates have been finalized.

c. The lower-tier auditor will also provide comments on any transferred costs not covered by an interplant work order.

d. The lower-tier auditor will explain all suspended or disapproved costs in sufficient detail to enable the prime auditor to prepare necessary DCAA Form 1s.

6-804 Corporate or Home Office Audits

The contractor's home or group office comprises the general corporate or divisional headquarters responsible for the management of business carried out at various plants, branches, divisions, or subsidiaries of the organization.

a. The home office is responsible for the overall administration and management of the operations performed under its general guidance and incurs expenses that are allocable to the operations carried out at the various plants, branches, divisions, or subsidiaries.

b. Some home or group office services may not be of a general nature but are performed for a particular plant or division. Under such conditions, the associated costs may be directly charged to the plant or division. Treat these transactions as intracompany billings covered by the audit procedures outlined for interdivisional transactions (6-313).

6-804.1 Audit Responsibility

a. The home office auditor is responsible for the audit of all corporate or home office expenses distributed to the various segments of the corporation irrespective of how such expenses may be charged to the segments.

b. There is, however, a significant corollary responsibility placed on lower-tier auditors. They must develop sufficient information and necessary visibility to permit effective evaluation by the home office auditor. For example, lower-tier auditors, in cooperation with the contract audit coordinator (CAC) and home office auditors, may identify overlapping or duplicative effort between the home office and operating entities. The CAC program (15-200) was established, in part, to improve communication and visibility in this important area. Accordingly, take appropriate measures to assure that effective coordination is accomplished among the home office auditor, the plant auditor, and the CAC.

c. The audit scope will depend to a large extent on the overall value and percentage of government contracts the contractor is performing and the amount of home office expenses allocated and assigned to government contracts. When appropriate, the corporate auditor should perform the audit during the contractor's fiscal year.

d. The corporate auditor should resolve audit problems, such as inequitable allocation methods or corporate policies, as soon as possible to prevent undue delays of overhead audits at the various segments. In this connection, refer to 15-200 for the CAC program procedures. Plant level auditors should specify dates by which home office reports are needed in the audit request.

6-804.2 Audit Procedures

a. Guidance in Chapters 4 and 6 are applicable to the audit of home office expenses. In reviewing home office expense pools, pay particular attention to the expense types which may not be applicable to the business as a whole, such as those applicable only to a particular group of products, group of plants, or

only to those products sold through certain channels or to certain customers.

b. The corporate auditor should review accounts not included in the expense pool for the possibility that they are applicable to government contracts. These accounts include other (or miscellaneous) income and expense accounts, reserves for contingencies, surplus, and others. (See 6-500.)

c. The corporate auditor should review tax returns, corporate minutes, reports filed with regulatory bodies (such as SEC filings), and financial statements for their impact on the contractor's organization, operations, and claimed costs. (see 3-151.) The results of this review should be coordinated with, and written confirmation provided to, cognizant lower-tier auditors to help comply with mandatory annual audit requirement relating to the review of tax returns and financial statements (MAAR 4).

d. The corporate auditor should furnish copies of consolidated financial statements, including notes thereto, to cognizant lower-tier auditors.

6-804.3 Cost Accounting Standards

Cost Accounting Standard 403 (Allocation of Home Office Expenses to Segments) is particularly important in reviewing the allocability of home or group office expenses. The need for assuring compliance imposes special requirements on both the home office auditor and lower-tier auditors, and close coordination and interface between these auditors is essential. All auditors involved in the review and analysis of home or group office expenses will observe the specific guidance contained in Chapter 8.

6-804.4 Audit Reports

a. The higher-tier auditor normally should issue audit reports annually, but also report significant findings when discovered. The narrative section of the report should contain summary comments on unsatisfactory contractor policies and procedures affecting contract costs at the plant level to alert those auditors to conditions that may require special emphasis.

b. Audit reports should provide sufficient detail and information for the the

plant level auditors to identify and evaluate cost allocations considering the circumstances or specific provisions of their contracts.

c. Reports distributed to plant or division level auditors should not divulge "contractor confidential" information which the contractor itself does not release to the plant or division level. A factor representing the percentage of questioned or disapproved allocated home or group office expenses may be all that is required at the plant or division level.

6-805 Offsite Locations (including overseas locations)

The contractor may maintain books and records at locations different from the site of physical work performance. For purposes of this section, auditors at locations where contractors' books and records are maintained are referred to as prime auditors and those where the work is physically performed as offsite auditors. Both prime and offsite auditors must establish adequate communication to assure effective interface.

6-805.1 Audit Responsibility

a. The prime auditor retains responsibility for the audit of the primary accounting records and approval of costs under government contracts. In this connection, the prime auditor will coordinate the overall plan or program, including assist audit requests, with the offsite auditor to assure proper integration of audit efforts at the respective locations. The assist audit request should include, as a minimum, a listing of current employees at the offsite location, the name, title, and telephone number of the offsite contractor representative, a listing of contractor project numbers active at the offsite location, a cross-reference to active government contract numbers and types, and a copy of a current payroll distribution. It is especially important that the prime auditor notify the offsite auditor of special provisions or sensitive areas concerning contract performance. The offsite auditor has a corollary responsibility to apprise the prime auditor of any auditable work or additional areas

of audit coverage at the offsite location which have not otherwise been identified.

b. The offsite auditor will time-phase general areas of audit coverage at the offsite location to coincide with the prime location's overall plan. The offsite auditor should initiate physical observations and coordination with offsite contract administration officials.

c. Where warranted, the prime auditor(s) should make periodic visits to offsite locations to coordinate audit activity. The prime and offsite auditors should discuss any unresolved problems between them through regional channels. (See 6-806.)

d. These responsibilities also include satisfying the applicable portions of the mandatory annual audit requirement related to auditable subcontract/assist audits (MAAR 12).

6-805.2 Audit Reports

a. The format and content of the assist audit report will conform with the general requirements of Chapter 10.

b. The offsite auditor will address assist audit reports to the prime auditor. All assist audit reports with positive findings shall contain a recommendation for a followup assist audit whenever one is considered necessary. When audit results involve questioned costs or require further action at the prime location, the prime auditor will advise the offsite auditor of the disposition of the audit findings.

c. The offsite auditor will issue reports to local contract administration officials concerning matters of local interest or in response to requests from the local officials. The offsite auditor will furnish copies of reports to the prime auditor.

6-806 Differences of Opinion Between DCAA Offices

In the exchange of information and ideas in the performance of assist audits, it is possible that significant differences of opinion on administrative procedures or technical accounting matters may develop. Auditors encountering such differences in performing audit assignments will forward the information to their

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respective regional offices. If the directors of the respective regions cannot resolve the differences, or if the differences are resolved, but the matters involved would be of interest to Headquarters, either or both regional directors will forward promptly to Headquarters, At-

tention PAD, a report containing sufficient details regarding the differences involved including, where appropriate, the conclusions reached. Reporting to Headquarters on problem areas encountered in the administration of the CAC program is covered in 15-210.2.

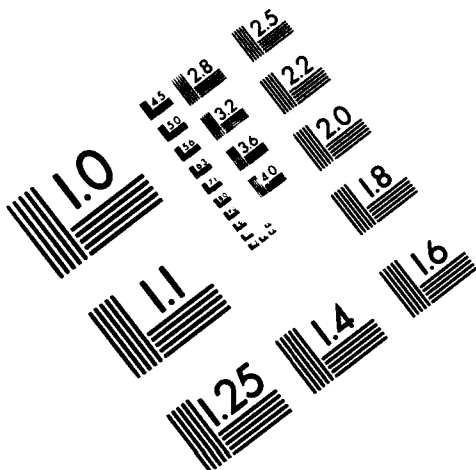
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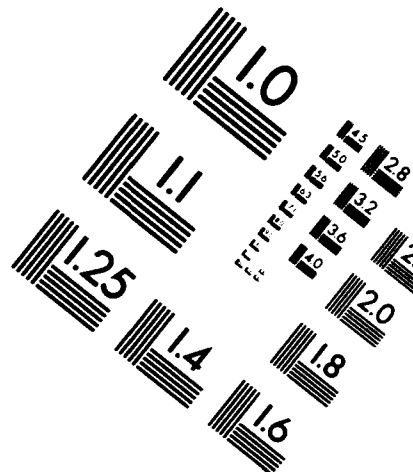
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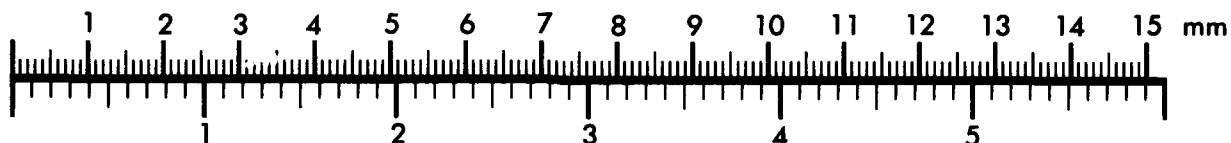
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Association for Information and Image Management

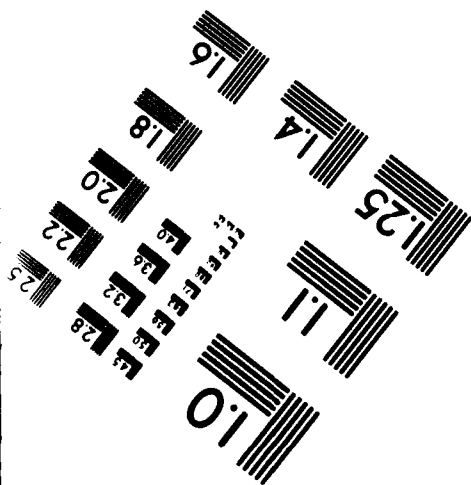
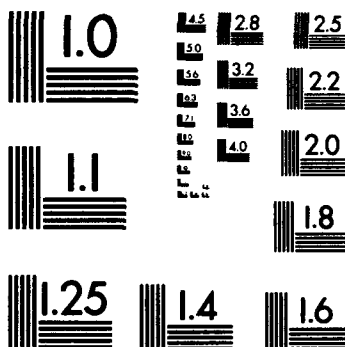
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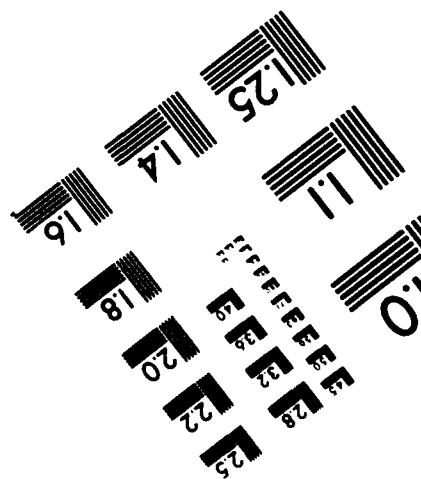
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6-900 Section 9 — Notices of Costs Suspended and/or Disapproved under Cost Reimbursement Contracts

6-901 Introduction

This section states the audit guidance and procedures to be followed for effecting suspensions and disapprovals of costs under cost reimbursement contracts and the issuance of DCAA Form 1, Notice of Costs Suspended and/or Disapproved under Cost Reimbursement Contracts.

6-902 General Guidance for Suspensions and Disapprovals

a. In general, an item of cost, either direct or indirect, which lacks adequate explanation or documentary support for definitive audit approval or disapproval should be suspended until the required data are received and a determination can be made as to the allowability of the item. Suspensions may also be used to:

(1) Reduce the fixed-fee when the interim amount claimed for payment is in excess of the amount authorized by the contract.

(2) Establish the necessary withholding reserves required by the contract terms when the contractor fails to do so.

(3) Provide for the correct amount of current reimbursements of costs that are otherwise allowable but which have not met the requirements in 6-1005c and 6-1006.

b. Costs claimed by the contractor for which audit action has been completed, and which are not considered allowable, will be disapproved. Disapproved cost may comprise any of the following:

(1) Items specifically limited or excluded by FAR Part 31 or other terms of the contract.

(2) Items which, although not specifically unallowable under (1) above, are determined, in accordance with FAR Part 31, to be unreasonable in amount, contrary to generally accepted accounting principles, or not properly allocable to the contract in accordance with the relative benefit received or other equitable relationship.

(3) Items disapproved at the direction of the ACO (DFARS 242.803(b)(ii)(B))

c. Costs which the auditor determines should be suspended or disapproved should be discussed with the contractor to ensure that the auditor's conclusion is based upon a proper understanding of the facts and to inform the contractor of the auditor's determination. If the contractor agrees that the costs in question should be suspended or disapproved, one of the following actions will be taken:

(1) Where the costs have not yet been submitted on a reimbursement voucher, arrangements will be made to ensure exclusion of the costs from any future reimbursement claims. The auditor shall maintain a record of improper contract costs which the contractor has agreed to deduct or exclude from its claims on public vouchers.

(2) Where the costs have already been included in provisionally approved reimbursement vouchers, the auditor may issue a DCAA Form 1, or as an alternative the contractor may deduct the amount on the next voucher submitted.

d. The issuance of a DCAA Form 1 should not be delayed until the auditor is prepared to issue an audit report if the cost to be disapproved has been reimbursed through interim billings. If an audit finding has been presented to the contractor and the contractor does not agree with the questioned costs, the auditor may prepare and issue a DCAA Form 1 even though the audit report will not be issued until other portions of the audit are completed.

e. The auditor is responsible for keeping the ACO advised of issues which have the potential for becoming the subject of a DCAA Form 1 and should consult with the ACO before issuing a DCAA Form 1, or its equivalent in the case of a non-DoD agency. This will permit the auditor to ascertain whether the ACO (1) has any additional data which would either support or modify the audit findings, and (2) concurs or nonconcurs with the proposed cost suspension or disapproval. The auditor may also refer the matter to the regional office for guidance, particularly in those cases where the ACO indicates

nonconcurrence with the proposed audit action. The regional office, in turn, may consider it desirable to consult Headquarters before reaching a decision. The consultations and discussions held with the ACO and higher level audit personnel should be expedited so that audit action can be completed on a timely basis. The issuance of a DCAA Form 1 triggers the ACO's involvement in the audit determination process (6-708).

f. If the contractor does not agree that the costs in question should be suspended or disapproved, and the auditor has taken the action prescribed in e. above, the auditor will issue a DCAA Form 1 (6-903) to effect suspensions and disapprovals of costs or fees claimed for payment on contractors' reimbursement vouchers.

g. Occasionally a contractor may underbill and wait until the final indirect rates are settled before billing the government. Where such an underbilling has occurred and the auditor and the contractor do not agree on the allowability of the amounts contained in the contractor's claim, the auditor should issue a DCAA Form 1. The amount of questioned costs with which the contractor did not agree will be shown in the designated block on the DCAA Form 1. After the explanatory paragraph(s), a statement shall be provided explaining that no action is necessary to recoup the questioned amount as the contractor has not been reimbursed for it. The following statement is suggested and may be modified and/or expanded to suit particular circumstances:

"The purpose of this DCAA Form 1 is to initiate ACO action in rendering a final decision on the questioned costs associated with the issue described herein with which the contractor does not agree. At the present time, no action is required to recoup the questioned amount as the interim billing rate used by the contractor during FY 19xx was low enough to preclude reimbursement of the questioned costs on an interim basis.

"However, should the contractor bill these costs before this issue is resolved, this DCAA Form 1 will be attached to the request for payment

for the purpose of disapproving the costs."

h. When the auditor cognizant of a home office determines that certain amounts should be suspended or disapproved, he/she is responsible for (1) discussing the costs with the appropriate home office representatives; (2) consulting with the CACO, if appropriate; (3) preparing computations to show the allocation of the suspended/disapproved costs to each receiving entity; and (4) advising the auditor cognizant of the receiving entity as to the description of the cost element to be suspended or disapproved, the amount allocable to the entity, and the reasons for the action. A copy of this advisory notice should also be sent to the cognizant CACO and the contractor's home office representative. The auditor cognizant of the entity receiving the costs to be suspended or disapproved should prepare a regular or blanket DCAA Form 1, as appropriate, listing all affected contracts, and showing the computations to the contract level.

i. For special administrative procedures to be followed in processing suspensions and disapprovals related to non-DoD contracts refer to 15-100.

6-903 Types of DCAA Form 1

a. Suspensions and disapprovals affecting DoD contracts, and contracts of non-DoD organizations where the auditor has been granted the authority (15-103), will be accomplished by means of one of the following types of DCAA Form 1. Costs suspended or disapproved on NASA contracts are accomplished by means of a NASA Form 456 (15-105).

b. While individual delivery orders under Indefinite Delivery Type Contracts should be treated as if they were separate contracts, a DCAA Form 1 can be issued to effect a cost disallowance on one delivery order in order to recover an overpayment under another delivery order on the same contract.

6-903.1 Regular

Where the cost element to be suspended or disapproved is applicable to only one contract, a regular DCAA Form 1

will be prepared and issued as prescribed in 6-905.1.

6-903.2 Blanket

Where the cost element to be suspended or disapproved is applicable to more than one contract, a blanket DCAA Form 1 will be prepared and issued as prescribed in 6-905.2. The blanket DCAA Form 1 will contain a description of the issue involved and will list all affected contracts, showing the computation to the contract level. Although all affected contracts are listed on the blanket DCAA Form 1, it may be possible to recoup a significant amount of the costs on only part of the contracts. In such cases the auditor may elect to process the DCAA Form 1 against interim billings for only those contracts containing the major portion of the costs to be suspended or disapproved. Once the issue is settled, the other contracts should be adjusted as necessary. Contract audit closing statements should reflect reductions for all outstanding DCAA Form 1 suspensions and disapprovals applicable to the contract even though the Form 1 has not been previously processed against interim billings under the contract due to materiality considerations.

6-904 Follow-up Action on Suspensions and Disapprovals

a. It is expected that within a reasonable time after issuance of a suspension, the contractor will submit the required explanations, documentation, data, or justification in support of the suspended costs. At that time, the auditor will complete the review and determine the allowability of the items involved. Auditors will make all reasonable efforts to obtain the additional information required for an audit determination as promptly as possible. When such efforts are not successful, the auditor, after the lapse of a reasonable period of time, may process a DCAA Form 1 to effect the disapproval of the suspended item. If the contractor disagrees with this determination, it may elect to assert a claim with the contracting officer pursuant to the "Disputes" clause of the contract(s).

b. When a reimbursement voucher contains a resubmission of items of cost or fee which were previously suspended by DCAA Form 1, the contractor will show each such item as a separate line item on its SF 1035 in the current period column of the section entitled "Contract Reserves and Adjustments" (see DCAAP 7641.90). All these items will be combined into one figure in the cumulative amount column. A final audit determination on all suspended items will be made by the auditor prior to or at the time the completion voucher under the contract or subcontract is processed and the contract closing statement is issued.

c. Where the contractor's claim for costs disapproved by a DCAA Form 1 is sustained by the ACO or under the decision and appeals procedures, the auditor will approve the costs determined acceptable when resubmitted by the contractor in a reimbursement voucher.

6-905 Preparation of DCAA Form 1

The auditor is the authorized representative of the contracting officer for the purpose of issuing a DCAA Form 1. Only the auditor shall prepare the form. The auditor should prepare a separate DCAA Form 1 for each major issue. This procedure facilitates tracking the status of the issue should the contractor appeal the DCAA Form 1. Instructions for the preparation of authorized types of DCAA Forms 1 are presented in the following paragraphs. Regional Audit Manager (RAM) review is required prior to issuance of all Forms 1, as well as all related rebuttals and response letters.

6-905.1 Regular

a. The information to be shown on the regular form will be in conformity with the following instructions, which are keyed to the letters on the specimen DCAA Forms 1 and 1-c (Figure 6-9-1 and 6-9-2).

(1) Contract Number. Insert the number of the contract, and, if appropriate, the job, task, or project order thereunder.

(2) Notice Number. Insert the sequence number of this DCAA Form 1. A separate series of consecutive numbers of DCAA Forms 1 beginning with number 1

will be used for each contract, job, task, or project order for which a separate voucher series of numbers is used. (See DCAAP 7641.90.)

(3) Disbursing Office. Show the name and address of the applicable disbursing office.

(4) Contract Administration Office. Show the name and address of the applicable office.

(5) Signature and Date of Notice. The auditor responsible for the preparation of the DCAA Form 1 will manually sign the original and insert the date signed.

(6) DCAA Auditor Address. Insert the name and address of the FAO.

(7) Contractor's Acknowledgment of Receipt. Do not fill in these three blocks when the form is prepared. Obtain the contractor's acknowledgment per 6-906b.

(8) Description of Items and Reasons for Action. The auditor shall insert in this space a clear and concise description and identification of each item suspended or disapproved. The reasons for action must clearly and specifically state the grounds for suspension, or disapproval. Since the DCAA Form 1 is, in essence, an audit report, the reporting standards in 2-400 will be complied with in its preparation. In the event a lengthy narrative is required such as may be needed to describe a large or complicated item of cost suspended and/or disapproved, the typing may be extended across the entire page, or a brief summary may be made, attaching the details on plain paper. If there are numerous items, they should be briefly itemized and totaled before the detailed explanations begin, so that the total amounts of costs suspended and/or disapproved appear no later than the first or second page of the form.

b. Sufficient copies will be prepared to provide the distribution required by 6-906.

c. The amount suspended and/or disapproved will be deducted on a current public voucher in the manner provided by 6-907.

6-905.2 Blanket

a. Where use of a blanket form is appropriate (see 6-903.2), one DCAA Form 1, suitable for reproduction, will be

prepared in accordance with the following instructions.

(1) The contractor's name and address will be shown in the space provided.

(2) A description of the cost element to be suspended or disapproved, the amount applicable to each affected contract, and the reasons for the action will be shown in the space provided. If the information cannot be conveniently shown in such space, a brief, introductory statement will be furnished, generally describing the items and reasons for the audit action. Amounts suspended or disapproved applicable to each affected contract and detailed explanations will be stated in exhibits or other attachments, and appropriate reference will be made to such data in the introductory statement. For example, in the case of indirect costs disapproved based on the auditor's determination of final indirect cost rates, the foregoing may be shown on the blanket DCAA Form 1 as follows, modified as appropriate in the circumstance:

"For the Fiscal Year ended _____, Factory, Engineering, and General & Administrative expense reimbursed to the _____ Company under this contract in excess of amounts determined allowable are disapproved. The disapproved amounts allocated to this contract are indicated by check mark on Exhibit A."

(3) The blanket form, including supporting exhibits or other attachments, if required, will be reproduced in the quantities required by 6-906 for each contract to which the suspended or disapproved cost is applicable.

(4) The applicable contract number, notice number and date, and public voucher number will be inserted for each contract on all copies of the reproduced form required for such contract. On each set of forms so prepared, the amount suspended or disapproved applicable to the cited contract will be clearly checked in ink or red pencil on all copies. One copy in each set will be signed as prescribed by 6-905.1a.

b. The blanket DCAA Form 1 will be distributed in accordance with 6-906 for each affected contract. The amount sus-

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76-905.2b.

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pending or disapproved applicable to each contract will be deducted from the reimbursement claimed on a public voucher

for such contract in the manner provided by 6-907.

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Figure 6-9-1

**Figure 6-9-1
DCAA Form 1**

DEFENSE CONTRACT AUDIT AGENCY NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED		PAGE ____ OF ____ PAGES(S)	
TO: (Name and Address of Contractor)	Contract Number (1)	Notice Number (2)	
	Disbursing Office (3)	Contract Administration Office (4)	
<p>1. This notice is issued pursuant to the authority of DoD Directive 5105.36, as implemented by the Federal Acquisition Regulation and DoD Far Supplement. It constitutes notice of costs suspended and/or disapproved incident to the audit of contractor costs incurred under referenced contract(s). Description of items and reasons for the action are stated below.</p> <p>2. SUSPENDED COSTS, as referred to herein, are costs which, for the reasons stated below, have been determined by the undersigned to be inadequately supported or otherwise questionable, and not appropriate for reimbursement under the contract terms at this time. Such costs may be determined reimbursable after the contractor provides the auditor additional documentation or explanation as specified below.</p> <p>3. DISAPPROVED COSTS, as referred to herein, are costs which, for the reasons stated below, have been determined by the undersigned to be unallowable, that is, not reimbursable under the contract terms.</p> <p>4. If the contractor disagrees with this/these determinations, the contractor may (1) request in writing the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss his or her findings with the contractor and/or (2) file a claim under the "Disputes" clause of the contract(s).</p> <p>5. The auditor will submit copies of the acknowledged notice to the cognizant disbursing officer for appropriate action and to the cognizant contracting officer.</p>			
DCAA AUDITOR	Date of Notice (5)	Address (6)	Signature (5)
CONTRACTOR'S ACKNOWLEDGMENT OF RECEIPT—The contractor or its authorized representative shall acknowledge receipt of this notice to the DCAA auditor.			
Date of Receipt (7)		Name and Title of Authorized Official (7)	
ITEM NO.	Description of Items and Reasons for Action (8)	Amount of Costs	
		Suspended	Disapproved

DCAA Form 1
February 1988

Supersedes August 1987 Edition of DCAA Form 1

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Figure 6-9-2

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Figure 6-9-2
DCAA Form 1-C

DEFENSE CONTRACT AUDIT AGENCY NOTICE OF CONTRACT COSTS SUSPENDED AND/OR DISAPPROVED (Continuation Sheet)		PAGE ____ OF ____ PAGES(S)
CONTRACTOR		NOTICE NUMBER (2)
ITEM NO.	DESCRIPTION OF ITEMS AND REASONS FOR ACTION (Continued)	
	(8)	

DCAA FORM 1-C Supercedes August 1987 Edition of DCAA Form 1-C
February 1988

DCAA Contract Audit Manual

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76-906

6-906 Distribution of DCAA Form 1

a. The distribution pattern below was developed by DoD procurement personnel to ensure that all interested government representatives receive timely notification of the status of suspension or disapproval actions and to accommodate legal requirements about the contractor's

appeal rights. Where satisfactory local arrangements can be made to accomplish these purposes through a more limited distribution, such action should be taken. In the case of issues having corporate-wide impact, a copy for return to the CACO should be provided in addition to the distribution noted below.

Advance Distribution at Time of Issuance	
Contractor (two acknowledgment copies, one each for return to the auditor and to the administrative contracting officer)	Original and 3 Copies
Administrative Contracting Officer	1 Copy
Audit File	1 Copy
	Original and 5 Copies
Distribution as Attachments to Reimbursement Vouchers	
DCAA Form 1 will be attached to the SF 1034 and each copy of the SF 1034s on which the deduction is made.	8 Copies
Total DCAA Forms needed	Original and 13 Copies

b. It is important for the auditor and the ACO to obtain the contractor's acknowledgment of the receipt of DCAA Form 1 on the copies provided for that purpose. Where the auditor personally presents the DCAA Form 1 to the contractor, he/she should obtain the required acknowledged copies and immediately forward one to the ACO. Where the DCAA Form 1 is mailed to the contractor, rather than personally presented, it should be sent by certified mail, return receipt requested, and the contractor shall be advised to forward the acknowledged copies of the DCAA Form 1, one each to the auditor and the ACO. This procedure shall be used in any case where the contractor refuses to acknowledge receipt of the DCAA Form 1.

6-907 Deductions on Public Vouchers for Suspensions and Disapprovals

a. If it appears that the full immediate deduction of a cost suspension or disapproval might seriously impair the contractor's ability to continue contract performance, the auditor should consult with the disbursing officer concerning possible use of FAR 32.613 procedures regarding deferred payments of contract debts.

b. The auditor shall insert in the differences block of the public voucher, SF 1034, the total amount suspended and/or disapproved as shown on the DCAA Form 1, and the net amount provisionally approved, as follows:

DCAA Form No. \$()
Net Amount Approved \$

The auditor should ensure that the DCAA Form 1 amount is shown as an offset to cumulative billings in the "Contract Reserves and Adjustments" section of the SF 1035 attached to the next public voucher (see DCAAP 7641.90).

c. If the amount of the deduction is more than the amount of the public voucher, the auditor shall apply the installment method of deductions to this and subsequent public vouchers, until the amount is fully liquidated against the contractor's claims. Public vouchers with zero amounts must be forwarded to the disbursing office for appropriate action.

6-908 Contractor's Request for Reconsideration or Claims of Disapproved Costs

a. Following the issuance of a DCAA Form 1, the contractor may (1) request the cognizant ACO in writing to consider

whether the unreimbursed costs should be paid and to discuss his or her findings with the contractor or (2) submit to the ACO a claim for disapproved costs in accordance with FAR 33.2 (Disputes and Appeals). Arrangements should be made for ACOs to notify the auditor promptly of any claims they may receive. The ACO will normally make a written determination as promptly as practicable on contractor written requests for reconsideration, but when a formal claim is filed, the ACO should make a final decision within 60 days. If a contractor disagrees with the ACO final decision regarding a claim, the contractor may appeal the decision to the ASBCA or the Court of Federal Claims.

b. Written determinations or final decisions may sometimes involve complex issues and significant dollar amounts. Moreover, they may have an impact far wider than the particular transaction at issue. Generally, the ACO will seek legal counsel and advice from others, including the auditor. In these cases, the auditor shall cooperate with the ACO by furnishing any additional information and audit explanations necessary to permit him or her to reach a conclusion. In the event the ACO does not sustain the contract auditor's cost disapproval, DoD Directive 7640.2 requires the ACO to comply with the documentation and review procedures prescribed by his/her DoD component prior to final disposition of the disapproved cost (see 15-603). In this connection, DCMC procedures are stated in paragraph 31.2-3g of DLA Manual 8105.1.

c. When a claim of disapproved costs is decided, in whole or in part, in the contractor's favor, the ACO will advise

the contractor to resubmit on its next public voucher the amount determined acceptable by the ACO. The amount of the resubmission shall be shown as a separate item in the section on the SF 1035 headed "Contract Reserves and Adjustments" (see DCAAP 7641.90). The copy of the ACO's decision sustaining the contractor's claim which is furnished the auditor will be retained with the auditor's copy of the resubmission voucher as supporting documentation.

d. Refer to 15-603 for guidance on reporting of ACO reinstatements and issuance of reports to the ACO on audit determined rates and DCAA Forms 1 when the auditor cannot reach an agreement with the contractor.

6-909 General Accounting Office Notices of Exception

a. Notices of exception issued by the General Accounting Office are addressed to the disbursing officer. The disbursing officer usually recovers the questioned amount by an immediate deduction from amounts otherwise due the contractor. The contractor is notified of the action taken and of its right to file a reclaim voucher.

b. The auditor does not have responsibility for making replies to the General Accounting Office Notices of Exception. When the disbursing officer requests the auditor's advice and comment on an exception, the auditor will furnish all available information to assist him or her. Such information shall include an opinion as to whether the submission of an explanatory reply is likely to result in the withdrawal of the exception by the GAO.

6-1000 Section 10 — Responsibilities for Processing and Approval of Interim and Completion Cost-Reimbursement Vouchers**6-1001 Introduction**

This section provides information on the audit responsibilities for the processing and approval of the contractor's interim and completion reimbursement vouchers. Additional guidance on terminated cost-type contracts and processing of non-DoD reimbursement vouchers is contained in 12-400 and 15-100, respectively.

6-1002 General

a. Contractors submit reimbursement vouchers or invoices (herein referred to as vouchers) to obtain interim and final payment under cost-reimbursement, time-and-materials and labor-hour contracts and the cost-reimbursement portions of fixed price contracts. A cost-reimbursement type contract provides for payment to the contractor of the allowable costs incurred in performing the work or services prescribed in the contract. This type of contract specifies an estimate of total cost for the purposes of (1) obligating funds and (2) establishing a cost ceiling which the contractor may not exceed, except at its own risk, without the approval of the contracting officer. The contract may also provide for the payment to the contractor of a fixed fee, or a target fee subject to subsequent incentive adjustment dependent upon prescribed contract performance or cost factors. Conversely, a cost-sharing contract may limit reimbursement to the contractor to an agreed portion of the total allowable costs, and provide for the remaining portion to be absorbed by the contractor in consideration of expected compensating benefits. A time-and-materials contract provides for acquiring supplies or services on the basis of (1) direct labor hours at specified fixed hourly rates that include wages, indirect expenses, and profit; and (2) materials at cost, including material handling costs, if appropriate. A labor-hour contract is a variant of the time and materials contract, differing in that materials are not

supplied by the contractor. The various types of contracts described above are hereafter referred to as cost-reimbursement type contracts for purposes of this section and are more fully explained in FAR Part 16, Subparts 3, 4, and 6, plus applicable supplements.

b. A fixed price contract obligates the contractor to complete physical performance of the contract at the stipulated price(s). The failure to complete performance subjects the contractor to possible government termination for default. Under a cost-reimbursement type contract, however, although the contractor is expected to use its best efforts to complete performance, the contractor is not obligated to continue performance under the contract if it involves the incurrence of costs in excess of the estimated total cost stated in the contract.

6-1003 Responsibility for Examination and Approval of Reimbursement Vouchers

a. The authority and responsibility for audit examination and approval for payment of contractors' claims (public vouchers) under cost-reimbursement type contracts are set forth in Department of Defense Directive No. 5105.36, subject: Defense Contract Audit Agency (see 1-1S1) as implemented in FAR 42.803(b) and applicable supplements.

b. Under cost-reimbursement contracts, the cost-reimbursement portion of fixed price contracts, letter contracts that provide for reimbursement of costs, time-materials contracts, and labor-hour contracts, the contract auditor is the authorized representative of the contracting officer to (1) receive reimbursement vouchers, interim rate adjustment vouchers, and final rate adjustment vouchers directly from contractors, (2) approve for payment or adjustment those vouchers found acceptable, and (3) suspend payment of questionable costs (see 6-905). The auditor will assure that completed vouchers are forwarded to the cognizant disbursing officer for payment.

c. If the review of a voucher raises a question regarding the allowability of a cost under the contract terms, the auditor, after informal discussion as appropriate, will issue a DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved". Guidance on the preparation and submission of DCAA Form 1 is contained in 6-900. The Form 1 will be submitted simultaneously to the contractor and the disbursing officer, with a copy to the cognizant contracting officer, for deduction from current payments with respect to costs claimed but not considered reimbursable. If the contractor disagrees with the deduction, it may (1) submit a written request to the cognizant contracting officer to consider whether the unreimbursed costs should be paid, (2) file a claim under the Disputes clause, or (3) do both. The contracting officer may direct the auditor to issue a Form 1 for any cost that he or she believes should be suspended or disapproved.

d. The auditor will approve separate fee vouchers and fee portions of vouchers for provisional payment in accordance with the contract schedule and any instructions from the administrative contracting officer (ACO).

e. Completion vouchers will be forwarded to the ACO for approval after audit review as prescribed in 6-1008.1b.

f. The primary purpose of the examination and approval of interim public vouchers is to provide reasonable assurance that the amounts claimed are not in excess of that which is properly due the contractor in accordance with the terms of the contract. The extent of audits of individual interim vouchers should be based upon the contractor's integrity, its financial condition and the adequacy of its internal management controls and procedures. It is not intended that interim public vouchers submitted by contractors under cost-reimbursement type contracts be individually audited except in those very unusual instances where the auditor has concluded that he or she cannot place reasonable reliance upon the contractor's cost representations or billing procedure (maximum control risk). Guidance pertaining to the auditor's review of the internal control structure is provided in Chapter 5 and 6-1006,

guidance pertaining to audits of interim public vouchers is provided in 6-1007 and guidance regarding completion vouchers is in 6-1008.

6-1004 Preparation and Submission of Claims for Reimbursement by Contractors

a. Cost-reimbursement type contracts provide that the contractor may submit periodic claims for reimbursement of costs and fee on government public voucher forms SF 1034 and SF 1035 or their equivalent. Detailed information concerning the preparation, submission and processing of these forms is presented in DCAAP 7641.90. This pamphlet is available for distribution to contractors.

b. Audit offices receiving requests from contractors for public voucher forms will advise contractors that they may be obtained from the appropriate ACO or from the Government Printing Office at nominal cost.

c. Contractors' interim reimbursement claims will be forwarded for payment to the disbursing officer after appropriate review and approval by the auditor to insure that such payments are consistent with the terms of the contract. These interim payments are provisional in nature and are subject to retroactive adjustment upon the determination of the allowability of costs claimed. The allowable cost and payment clause at FAR 52.216-7 contained in each cost-reimbursement type contract states in part: "At any time or times before final payment, the Contracting Officer may have the Contractor's invoices or vouchers and statements of cost audited. Any payment may be (1) reduced by amounts found by the Contracting Officer not to constitute allowable costs or (2) adjusted for prior overpayments or underpayments." A similar clause is contained in time-and-materials and labor-hour contracts (FAR 52.232-7). Guidance concerning the review and processing of interim vouchers is provided in 6-1007.

d. Upon completion of the contract, the contractor is required to submit a voucher designated as "completion voucher" together with such other docu-

ments as are prescribed by the contract. Approval and payment by the government of the contractor's completion vouchers constitutes complete and final payment to the contractor, except for any items reserved by qualification of the contractor's Release of Claims. Detailed instructions relative to submission and processing of these documents are included in DCAAP 7641.90 and 6-1008.

6-1005 Determination of Allowable Costs

a. Each cost-reimbursement type contract provides that the allowable costs of performing the contract will be determined in accordance with the contract cost principles and procedures stated in that part of FAR Part 31 and applicable supplements which is appropriate for the type of contractor organization and work to be performed. Advance agreements or other provisions relating to the allowability or allocability of special or unusual items or categories of costs may also be incorporated into the contract when determined to be in the government's interest. This is to avoid possible subsequent disagreements regarding the reasonableness or allocability of allowable costs. Therefore, it is important that each contract be reviewed to determine its specific requirements and contractual terms and conditions. (See guidance on reviewing contract provisions in 3-200.)

b. Audits of contractors performing substantial government business will normally be made on a comprehensive basis, as contrasted with a contract by contract approach. The auditor will thus evaluate whether a review of the contractor's internal control structure would be more efficient or economical than transaction testing to reach an opinion on the accuracy and reliability of the contractor's records and cost representations. This decision should be documented in the permanent file. Accordingly, the guidance throughout CAM, particularly Chapters 5 through 8, will be used to perform the audit of contract costs. The nature and extent of audit effort required when the comprehensive approach is not taken will be influenced by such factors as the contract amount, the cost elements in-

involved, the nature of the work performed, the contractor's financial position, prior audit experience with the contractor, and the extent of any probable cost disapprovals. See 6-1006 for guidance regarding minimum steps required when audit experience with the contractor is limited. The extent of audit effort performed on individual vouchers under the comprehensive approach will depend upon the adequacy of the internal control structure, assessed control risk and the internal control weaknesses as identified in the permanent file. Guidance on internal control system reviews, assessing control risk and designing substantive testing is provided in Chapter 5.

c. The basis for preparing reimbursement claims is included in each cost-reimbursement, T&M or Labor-Hour contract, by the clause entitled "Allowable Cost and Payment" (see FAR 52.216-7 and 52.232-7) and by other special clauses such as withholding clauses, precontract clauses and overtime premium clauses as explained in 3-200.

d. When the contractor's billing system is not adequate for audit reliance upon reimbursement claims, the auditor will discuss the deficiencies with the contractor. If the contractor does not take corrective action promptly, the auditor will conduct sufficient transaction testing to quantify the government's exposure to premature or excessive payments and issue a DCAA Form 1 to suspend such costs until the contractor establishes acceptable billing procedures. Guidance pertaining to the preparation and issuance of Form 1s is contained in 6-900. There may be cases when the procedures are adequate except for certain types of cost, such as inadequate procedures for the billing of items or services purchased directly for contracts. If the auditor cannot determine whether all of the billed costs are eligible for reimbursement without the expenditure of undue time and effort, the suspension should be confined to only those costs affected by the inadequate procedures. On contracts awarded by a government agency outside of the DoD, the auditor will follow the procedures prescribed by that agency (see 15-100).

6-1006 Evaluation of Contractor's Procedures for Preparing Reimbursement Claims

a. Chapter 5 discusses the controls that should be in place in an adequate system. These include management review and approval, controls over reconciliation of recorded and billed costs, adjustment of cost and rates, exclusion of unpaid costs, timely payments, subcontractor's progress payments, preparation of estimates to complete, loss contract procedures and calculation of fixed fee and time and material withholds. Normally, these controls will be tested, after considering the contractor's monitoring and testing, to the extent necessary to assure the system is adequate, during the review of the billing system and related internal controls. (See Chapter 5 for guidance on the review of the internal control structure, assessing control risk and designing substantive testing.) In evaluating the acceptability of a contractor's billing system and its procedures for preparation of reimbursement claims, as a minimum perform the following audit steps, especially when audit experience with the contractor is limited. Additional effort may be required if the contractor has a preponderance of high-risk contract types.

(1) Determine whether a billing record, cost subledger, or other auditable billing system is maintained for all contracts providing for reimbursement of cost. Ascertain whether the record is reconciled for each accounting period by elements of cost with the applicable contract job order in the work-in-process ledger.

(2) Determine whether the billing procedures provide for the costs of items or services purchased directly for the contracts to be claimed for reimbursement only after payment. Evaluate whether the contractor promptly mails payment to its vendors. For this purpose, it is intended that cancelled checks be examined on a limited basis for indications of excessive intervals between dates prepared and dates paid, only when the auditor cannot satisfy himself or herself by a systems review or by other means that such payments are made on a timely basis. In

the case of claims for progress payments made to subcontractors, verify that the subcontracts require computation of progress payment amounts on the basis of cost standards similar to those stated in 6-1005c.

(3) Determine that overhead and G&A expenses are calculated on the basis of billing rates acceptable to the cognizant auditor or contracting officer. As stated in FAR 42.704, the contracting officer or auditor responsible for determining the final indirect cost rates ordinarily shall also be responsible for determining the billing rates. If there are no current established billing rates, follow the procedures contained in 6-700 to determine billing rates.

(4) Verify that the contractor is not delinquent in the payment of costs incurred in the performance of the contracts.

(5) Verify that the contractor has procedures established to insure that interim vouchers for cost-reimbursement contracts include fixed-fee withholds after payment of 85 percent until a reserve is set aside in accordance with contract terms. This reserve shall not exceed 15 percent of the total fixed fee or \$100,000, whichever is less.

(6) Verify that the contractor has procedures established to insure that 5 percent of the billable labor costs, not to exceed a total of \$50,000 per contract, is withheld from interim vouchers for time-and-materials or labor-hour contracts.

b. As discussed in 5-1105.b(2), the results of audits of other systems impact the scope of the billing system review. If the following steps have not been performed in the material and labor system audits, the auditor should perform them, considering the contractor's monitoring efforts, during the billing system audit:

(1) Verify that charges for material issued from the contractor's inventory for use on the contracts are identifiable on the billing record and are supported by journal vouchers recording issuance of contractor-owned material. Determine whether individual items of material can be traced to the issue document and whether item pricing conforms to acceptable practice and the contractor's established policy. Verify that the material is

issued for current use on the contract and not merely issued to an intermediate holding area for the purpose of obtaining reimbursement. Determine whether there is evidence that the contractor has discontinued buying material directly for the contracts and, instead, is buying the material for inventory in order to circumvent the actual payment requirement for obtaining reimbursement.

(2) Verify that weekly and/or biweekly direct labor entries in the billing record are based on the source documents for the journal vouchers distributing salaries and wages for the accounting period. Verify that any labor adjustments appearing in the billing record are supported by correction or reclassification journal vouchers. Verify, in a similar manner, incurred cost entries for direct travel and other direct in-house cost.

6-1007 Review and Approval of Interim Public Vouchers

a. The directives and regulations which establish the authority and responsibility of the auditor relative to the processing and approval of public vouchers are discussed in 6-1003. Guidance pertaining to the determination of allowable costs claimed by the contractor in public vouchers is contained in 3-2S1 and guidance regarding the clauses in cost reimbursement type contracts is contained in 3-200. Contractors are generally dependent upon prompt receipt of interim payments under cost-reimbursement type contracts to maintain a satisfactory financial position. Therefore, as an objective, interim vouchers will be reviewed and either (1) approved for payment and forwarded to the disbursing officer or (2) returned to the contractor for correction as quickly as possible, but not later than five working days after receipt. Since payments on interim public vouchers under cost-reimbursement contracts are made solely for financing purposes, they are not subject to the interest payment provisions of the Prompt Payment Act, Public Law 97-177 if they are not paid in a timely manner.

b. To the extent appropriate, the voucher review will be performed by clerical personnel in the respective field

offices, rather than by auditors. Instead of a complete review of all vouchers, sampling techniques should be used to select specific vouchers for review. The sampling plan and techniques to be used should be documented and updated annually. The elements reviewed and number of vouchers sampled will be based on the results of the internal control reviews or a decision to transaction test as documented in the permanent file annually. The selective review of vouchers should be considered in cases of financially sound contractors where audit experience indicates their internal controls and procedures for accumulating costs and preparing public vouchers are acceptable (low to moderate control risk). Audit guidance for determining the adequacy of the contractor's procedures for preparing reimbursement claims is in 6-1006 and in Chapter 5. The sampling techniques to be used should be approved by the auditor responsible for approval of the vouchers. The review will be limited to the following steps:

(1) Comparison of the information shown on the voucher with the related information on the FAO-prepared briefing cards or the contractor-prepared briefing cards if reliance can be placed on the contractor's work (see 3-202).

(2) Verification that amounts claimed for reimbursement of indirect costs are computed using the billing rates acceptable to the cognizant auditor or contracting officer. (See 6-1006.e above.)

(3) Verification that interim fees claimed are computed by the formula or basis in the contract. When the interim fee claim is related to the percentage of physical completion, a statement from the ACO covering this matter should have been submitted with the voucher.

(4) Verification that billable labor costs on time-and-materials or labor-hour contracts have been reduced by 5 percent until the maximum withheld amount of \$50,000 is reached, as required per FAR 52.232-7(a)(2).

(5) Determination that the voucher has been properly prepared and that payment for the items listed on the voucher is not precluded by any contractual provisions. See 3-202 for guidance on briefing and documenting briefs of contracts.

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(6) Test of the mathematical accuracy of extensions and footings. This will normally be done only if past experience with the contractor has revealed weaknesses in its billing procedures or if mathematical errors have been otherwise noted.

c. Interim public vouchers shall be provisionally approved by authorized auditors by signing the voucher in the space provided. As illustrated in DCAAP 7641.90, the auditor's name and title should be typed on the voucher by the contractor.

d. After provisional approval, interim public vouchers shall be forwarded to the disbursing officer for payment and subsequent distribution, as annotated on the vouchers. Amounts provisionally approved on public vouchers are subject to the audit of the contractor's records prior to the final settlement under the contract.

e. In the event that the contractor's public voucher contains an error, it should be returned to the contractor with a written explanation regarding the error that was found. The auditor can use the DCAA Form 1 (see 6-905) to correct errors in public vouchers which involve downward adjustments with which the contractor is in disagreement.

f. By arrangements made with disbursing officers, public vouchers to be returned to contractors for correction will be transmitted to the contractor via the cognizant auditor. Returned public vouchers should be reviewed to determine the reason for rejection to assure that any systemic problems are corrected or if not corrected are used to adjust control risk and substantive testing.

g. Special procedures for processing cost-reimbursement vouchers for non-DoD agencies are contained in 15-100.

6-1008 Processing of Completion Vouchers

This paragraph provides guidance for the review and processing of completion vouchers on completed or terminated cost-reimbursement type contracts and subcontracts (see 6-706.1 for additional comments on final rates). When processing completion vouchers on subcontracts the auditor should also review the guid-

ance on assist audits for other contract auditors in 6-802.

6-1008.1 Receipt of Completion Vouchers

a. Upon receipt of a completion voucher and the accompanying closing documents, the auditor will ascertain that they are prepared in accordance with the guidance contained in DCAAP 7641.90. The closing documents may include the following:

(1) Contractor's Release of Claims.

(2) Contractor's Assignment of Refunds, Rebates, Credits and other Amounts.

(3) Assignee's Release of Claims.

(4) Assignee's Assignment of Refunds, Rebates, Credits, and other Amounts.

b. The auditor should send an advance copy of the completion voucher and the accompanying closing documents to the ACO, by transmittal letter, so as to expedite settlement procedures. The auditor should retain the originals and all copies for submission with the contract audit closing statement. A copy of each document should be included in the audit workpackage.

c. For terminated contracts, the advance copy of the completion voucher will be submitted to the termination contracting officer (TCO) rather than to the ACO.

6-1008.2 Review of Completion Vouchers

a. The review of a completion voucher generally constitutes the final audit on the contract, since all the costs incurred on the contract should have been audited and cost issues resolved through final overhead and direct cost reviews. Therefore, if the contractor's internal controls are adequate, the auditor's review of a completion voucher prior to the issuance of a contract audit closing statement is primarily administrative in nature. See Chapter 5 and 6-1006 above for guidance on the review of internal controls. The extent and kind of testing required based on the review of internal controls should be available from the permanent file and should be documented in the working papers. When transaction testing would be more efficient or economical than a review of the internal control structure, make sure this decision is documented in

the permanent file and working papers. The following procedures should be performed prior to the issuance of the contract audit closing statement:

(1) Complete the audit of the contractor's operations and costs related to the contract for final overhead years not completed, including a review of contract provisions for any special cost considerations (see 3-202 for information on contract briefing).

(2) Reach a final audit determination on the allowability of all direct costs claimed under the contract by: reconciling the cumulative allowable cost by year to the final overheads; verifying that exceptions to the direct cost taken during the final overhead reviews have been deleted from the claim; verifying that exceptions noted in reviews in (1) above have been deleted from the claim; and, making sure that all auditable subcontracts and interdivisional transactions for which assist audits have been requested have been received, and that the amounts billed by the prime contractor do not exceed the costs accepted in the assist audit reports.

(3) Reach a final audit determination on the allowability of all indirect costs claimed by verifying the rates claimed to the audit determined final overhead rates, negotiated final overhead rates or approved quick closeout rates.

(4) For cost-sharing contracts, ascertain that only the government percentage of allowable costs is recovered.

(5) Verify the incurred labor hours by category for contracts with level-of-effort clauses. Compare the incurred hours to the estimated hours specified in the contract to determine if the specified level-of-effort was met.

(6) For time-and-materials (T&M) and labor-hour contracts, multiply the total labor hours incurred by the contractual hourly billing rates and compare to the total labor amounts claimed. Compare hours incurred by labor category to those specified in the contract. Reconcile claimed to booked material and/or other direct costs and determine that the appropriate material handling or G&A rate has been applied to the claimed costs.

(7) Review the disposition of ending inventory, if any, keeping in mind that

cost-type ending inventory belongs to the government, whereas ending inventory from fixed price incentive contracts belongs to the contractor and must be removed from the fee base.

(8) Determine that the total costs and fee billed do not exceed the allowable amounts and/or funding limitations in the contract.

(9) Determine that the amount of fixed, award, or incentive fee payable is calculated in accordance with the terms of the contract. Where the contract provides for an incentive fee based in part upon performance or quality objectives, the auditor should coordinate with the ACO to obtain the information necessary to determine the contract fee. Prepare recommendations on incentive fee, if applicable.

b. The auditor's signature will not be shown on the completion voucher, since the contract audit closing statement expresses the auditor's opinion on the contract as a whole.

c. The contract audit closing statement will be prepared following the guidance contained in 10-900.

6-1008.3 Timeliness of the Receipt and Review of Completion Vouchers

As indicated in FAR 4.804-1(a)(3) and applicable supplements, the standard time for the closeout of physically completed, cost-reimbursement type contracts by contract administration and purchasing offices for contracts requiring settlement of indirect cost rates is 36 months. The auditor should review the completion voucher and issue the contract audit closing statement in sufficient time to permit the ACO and PCO to close out such contracts within this time. Where circumstances are encountered which delay timely finalization of the audit, the auditor should try to resolve the condition causing the delay. If the reason for the delay appears to be a systems problem, the auditor should report the deficiency to the contractor and the ACO for corrective action. Some factors causing delay and guidance to resolve them are discussed in the following paragraphs.

a. Where indirect cost rates are to be settled by audit determination, the audi-

tor should assure that issues in contention do not extend over protracted periods of time because of discussions with and/or rebuttals from the contractor. If the contractor does not concur in the auditor's determination of rates, a DCAA Form 1 should be issued, as provided by 6-900.

b. Consideration should be given to those circumstances under which it is permissible to close out a physically completed contract. Even though the indirect cost rates may not have been negotiated or settled by audit determination for the period covering the final stage of contract performance, the contract may be closed using the quick closeout procedures described in 6-1009.

c. Where the contractor fails to submit the completion voucher timely, its responsibility to do so should be pointed out by referring to the provisions of FAR 52.216-7(h)(1), which states: "The Contractor shall submit a completion invoice or voucher, designated as such, promptly upon completion of the work, but no later than one year (or longer, as the Contracting Officer may approve in writing) from the completion date." If the contractor continues to be delinquent in submitting the completion voucher, the auditor should consider recommending to the ACO that the contract be closed out unilaterally.

d. In those cases where final assist audit reports on interplant billings or cost-reimbursement type subcontracts have not been issued, the auditor should formally contact the assist auditor stressing the urgency of final audit action. If the contractor is responsible for the audits, determine the reason for the delay, and if necessary, request the ACO's assistance in seeking timely contractor performance. If the audit issuance cannot be expedited, consider requesting assist audits.

e. Issuance of contract audit closing statements should not be delayed pending receipt of final patent and royalty reports by the contract administration office. It is the responsibility of the ACO, as part of the contract close-out process, to ensure that such reports are received and cleared.

f. Another case requiring special attention is when (1) the contractor does not submit the completion voucher after being reminded to do so and (2) the ACO requests an audit report in order to unilaterally close out the contract. Using 6-1008.2 as a guide, the auditor should determine from the information in the audit files the proper amount payable to the contractor for the contract performance and prepare a contract audit closing statement following the guidance in 10-900. The report should not refer to the review of a completion voucher since there was not one, and should include the following qualification:

"Our opinion is based upon cost data accumulated during audits of the contractor's cost accounting records. The government has not received a completion voucher reflecting the contractor's statement of allowable costs. Therefore, our opinion is qualified to the extent a completion voucher would identify information having material implications regarding the allowability of costs."

6-1009 Quick Closeout Procedures

a. The final period of performance under a contract is generally less than a full fiscal year. The direct and indirect costs incurred on an individual contract in the last fiscal year of its performance may be relatively small in amount, particularly if the contract is physically completed early in the year. In such cases it is generally mutually advantageous to the government and the contractor to close such contracts as soon as possible without waiting until after the end of the fiscal year and the subsequent final determination or negotiation of the indirect expense rates for the entire period.

b. FAR 42.708 provides for quick closeout procedures which allow the contracting officer to negotiate a settlement of indirect costs for a specific contract in advance of the determination of final indirect rates under specified circumstances. Within DoD, the rate certification specified in DFARS 242.770-2 must be executed for all billings to the government. Various DoD components have issued additional guidelines on the significance of indirect costs allocable to the

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specific contract in order to qualify for quick closeout procedures. Excerpts from applicable procurement directives appear in 6-10S1. However, it should be noted that the provision for quick-closeout procedures can be applied not only to the final fiscal year of a contract but also to all other open fiscal years with unsettled overhead rates if the criteria contained in FAR 42.708 are met.

c. The auditor should provide recommendations regarding the impact any contract being considered for quick closeout would have on the contractor's indirect expense pools and/or bases and acceptable indirect expense rates. The rates recommended should be representative of conditions during the final fiscal year of contract performance. Some alternative rate bases are:

- (1) the final rates agreed upon for the immediate preceding fiscal year;
- (2) the provisional billing rates for the current fiscal year; or
- (3) estimated rates for the final fiscal year of contract performance based on the contractor's actual data adjusted for anticipated FAR unallowables.

d. Because of the small amount of contract costs involved, the use of the quick closeout procedures should result in only an insignificant difference in the amount of indirect costs applied to the contract for the closeout period as compared with the amount which would have been applied if the contract were not closed until after the annual rates were established. In addition, the chargeback of gains or losses to other contracts is not in compliance with generally accepted accounting principles. Consequently, except for terminated contracts discussed in 12-407, no adjustment to compensate for any such difference should be made in computing the periodic indirect cost rates to be applied to other contracts performed during the period.

6-1010 Distribution of Public Vouchers

After provisional approval, interim public vouchers shall be forwarded to the disbursing officer for payment and subsequent distribution, as annotated on the vouchers. See 10-907 for distribution of completion vouchers.

**6-10S1 Supplement — Expediting Overhead Settlement on Completed DoD
Cost-Reimbursement Type Contracts — Extracts from Procurement
Directives**

1. FAR 42.708 Quick-closeout procedure

(a) The contracting officer responsible for contract closeout may negotiate the settlement of indirect costs of a specific contract, in advance of the determination of final indirect cost rates if all of the following occur.

(1) The contract is physically complete.

(2) The amount of unsettled indirect cost to be allocated to the contract is relatively insignificant. (Indirect costs will be considered insignificant when (i) the total unsettled indirect cost applicable to any one contract does not exceed \$500,000 and, unless otherwise provided by agency procedures, (ii) the cumulative unsettled indirect costs to be allocated to one or more contracts in a single fiscal year do not exceed 15 percent of the estimated, total unsettled indirect costs allocable to cost-type contracts for that fiscal year.)

(3) Agreement can be reached on a reasonable number of allocable dollars.

(b) Determinations of final indirect costs under the quick-closeout procedure provided for by the Allowable Cost and Payment clause at FAR 52.216-7 or FAR 52.216-13 shall be final for the contract it covers and no adjustments shall be made to other contracts for over- or under-recoveries of costs allocated or allocable to the contract covered by the agreement.

(c) Indirect cost rates used in the quick closeout of a contract shall not be considered a binding precedent when establishing the final indirect cost rates for other contracts.

2. DoD FAR Supplement 242.770-2

(a) The ACO shall not accept any proposal to establish billing rates or final indirect cost rates unless the costs have been certified by the contractor using the certificate of indirect costs in the clause

at 252.242-7001, Certification of Indirect Costs.

(b) The ACO will not agree to billing rates or final indirect cost rates unless they are based on a certified proposal.

**3. Defense Logistics Agency Manual
8105.1: 42.7-11 Quick Closeout Procedures**

a. Of necessity, the closing of physically completed cost-type contracts may be delayed pending annual establishment of final overhead rates. When it is apparent that contract closeout will be delayed for that reason, the ACO will determine the approximate total of indirect costs allocated to affected contracts. If the approximate total of such indirect costs does not appear to have a significant impact on the annual settlement of final overhead rates, and does not exceed 15 percent of the total indirect costs allocable to cost-type contracts for the contractor's fiscal year, the ACO and the contractor may agree upon an allocable amount of final overhead costs to be used for contract closeout purposes. This procedure should be limited to contracts with small dollar balances or to instances where indirect costs applicable to any one DoD contract do not exceed \$500,000.

b. All actions to establish allocable overhead costs for more timely closeout purposes should be supported by advisory audit reports commensurate in depth with the total of indirect costs involved. Where the ACO determines that the total of indirect costs is so small that the cost of auditing is not justified, the contracts may be closed by using rates established for the preceding fiscal year, or recommended by the price/cost analyst.

c. If use of the procedures outlined in subparagraphs a and b above, will result in inequitable settlements, contract closeout must be deferred until annual overhead rates are established.

d. In using these closeout procedures, the ACO should ensure that the contractor understands that the allocable overhead costs utilized for closeout purposes

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are final, are not precedent-setting, and are not subject to adjustment at the time of annual rate determination. Actions taken in accordance with this paragraph will be documented by the ACO and set forth in a contractually binding bilateral agreement which will provide for reim-

bursement of agreed-upon overhead costs under the affected contracts. While these agreements are not required to be submitted to the Board of Review, the DCMD Director, Contract Management, may require that they be reviewed by the Board.

6-10S2 Supplement — Billing System Review Considerations for Contract Types

1. General Considerations

a. Government contracts may arise from negotiation or from formal advertising. Contracts resulting from formal advertising must be either firm-fixed-price (FFP) or fixed-price contracts with economic adjustment and interim payments to the contractor, if any, are not based on cost. Reviews of contractor billing systems ordinarily do not address policies and procedures for billings on commercial and formally advertised government contracts.

b. Negotiated contracts are grouped into two broad categories: fixed price contracts and cost reimbursement contracts. Fixed price contracts may be firm-fixed-price, fixed-price with economic adjustment or fixed price with incentive provisions. Fixed price contracts may be eligible for progress payments, which are invoiced on SF 1443, "Contractor's Request for Progress Payment." Progress payments under fixed price contracts are limited to a predetermined percentage (the "progress payment percentage" specified in the progress payment clause) of the total contract price and do not include profit. Firm-fixed-price level of effort (FFP/LOE) contracts are classified as fixed price, but the data submitted on billings under such contracts closely resembles that submitted on time-and-materials (T&M) contracts in that profit is included in the direct labor billing rates.

c. Cost-type contracts include cost sharing, cost reimbursement and cost plus fixed fee, award fee or incentive fee contracts. Interim payment requests under cost-type contracts are submitted on SF 1034, "Public Voucher for Purchases and Services Other Than Personal" and SF 1035, the continuation sheet. Fee may be billed with cost or may be separately vouchered according to the contract terms, and includes a percentage of the fee up to a predetermined limit. T&M and labor hours contracts are also invoiced on SF 1034 and 1035, but profit is included in the price of a labor hour. Contract types are discussed in detail in

FAR Part 16. Standard forms are illustrated in FAR Part 53.

2. Special Considerations — Fixed Price Contracts

a. It is important to review the contract clauses affecting the contractor's right to receive interim payments based on cost. A fixed price contract may require first article approval (FAR 52.209-3 or -4) before the contract is eligible for progress payments. Progress payments must be liquidated against deliveries or other billable milestones under the contract before any amounts other than progress payments may be paid (FAR 52.232-16(b)). The progress payment and liquidation rates are specified on the SF 1443 in items 6a and 6b respectively.

b. The following example will illustrate the computation of allowable interim payments under a fixed price contract which is not in an overrun status. Assume that the contract requires the delivery of 5 widgets over a two-year period at a unit price of \$10,000; a total contract value of \$50,000 ($5 \times \$10,000$); that the liquidation rate is 80% and the progress payment rate is 80%. The contractor invoices the widgets as they are delivered. There is no standard form for invoicing deliveries. If at the time the first article is delivered the contractor has incurred \$12,000 of eligible progress payment costs and invoiced them on SF 1443s, it will have received \$9,600 ($80\% \times \$12,000$) of unliquidated progress payments. The government liquidates \$8,000 ($80\% \times \$10,000$) of this against the first article, leaving an unliquidated balance of \$1,600. The contractor will bill the government and receive a payment of \$2,000 ($\$10,000 - \$8,000$).

c. The contractor is required to report an estimate to complete on SF 1443, item 12b. The instructions to SF 1443 require that this estimate shall be made not less frequently than every six months. FAR 32.503-6(g) requires that if the estimated costs are likely to exceed the contract price, the contracting officer shall calculate a loss ratio factor and adjust future progress payments to exclude the element

of loss. Audit steps for review of the contractor's estimate to complete and a matrix for computation of the loss ratio factor appear in the standard audit program for progress payment reviews.

d. In addition to verifying that billed costs include only amounts properly recorded and, where required, paid in accordance with an approved cost accounting system, a billing system survey at a location having significant progress payment billings must include a review of the policies, procedures and controls for:

(1) Identifying requisite billing data (progress payment and liquidation percentages, first article approval, billing frequency, etc.).

(2) Assuring compliance with contractual billing conditions.

(3) Preparing and updating estimates to complete.

(4) Timely computation of loss ratio and progress payment reduction when appropriate.

3. Special Considerations — Flexible Fixed Price and Fixed Price-Level of Effort Contracts

As with FFP contracts, progress payments under fixed price incentive (FPI) contracts are made in accordance with FAR 52.232-16. From an interim billing standpoint, FPI contracts differ from FFP only in the profit computation. They must be audited prior to final payment because the incentive profit is based on a comparison of the actual to the target cost. In an FFP/LOE contract, the deliverable product is the labor hour. Accordingly, such contracts rarely provide for progress payments based on cost. In reviewing billing systems at contractor locations having a significant volume of FFP/LOE work, treat these contracts as if they were T&M.

4. Special Considerations — Cost-type Contracts

a. Because the government assumes a higher percentage of risk under cost reimbursement type contracts and because such contracts may contain any number of special provisions affecting billings (ceiling rates, unallowable or unallocable cost elements, key personnel, fee billing and retention, etc.), the accounting and billing system requirements for such contracts are more stringent than for FFP

and FPI contracts. Cost-type contracts permit inclusion in the periodic billing of all allowable and allocable paid costs and certain recorded but unpaid costs which do not exceed the contract ceiling or funding limitation, reduced by the contractor's percentage in the case of a cost-sharing contract; and such costs are provisionally reimbursed in full, subject to subsequent audit. Fee billings may be vouchered with cost or separately, depending on the contract terms which frequently provide for a fee retention pending contract completion and close-out.

b. In addition to verifying that billed costs include only amounts properly recorded and, where required, paid in accordance with an approved cost accounting system, a billing system survey at a location having significant cost-reimbursable work must include a review of the policies, procedures and controls for:

(1) Identifying requisite billing data (type of fee, billing procedures, including required supplemental data, frequency etc.).

(2) Assuring that appropriate controls for briefing contracts and adhering to contract provisions and contract ceilings are in place and functional.

(3) Monitoring progress under the contract to provide the data required by FAR 52.232-20b (the Limitation of Cost clause).

(4) Promptly adjusting indirect billing rates for revised budgetary data.

(5) Where applicable, promptly adjusting prior billings to reflect final rates and direct cost disallowances.

(6) Including Form I suspensions on subsequent vouchers as an offset to cumulative billed cost.

5. Special Considerations — T&M and Labor Hours Contracts

a. T&M and labor hours contract costs are vouchered on SFs 1034 and 1035. They are a mixed contract type, since labor is billed at price and other direct costs (ODCs) are billed at cost. T&M and labor hours contracts provide for billing direct labor hours at predetermined category rates which include all applicable burden and profit, and bill ODCs (and direct materials on T&M contracts) at cost plus applicable burden. These con-

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tracts permit billings up to a stated percentage of the contract value, and may or may not require that each invoice be adjusted to the limitation percentage.

b. T&M and labor hours contracts contain an inherent risk so high that they may be used only after the contracting officer executes a determination that no other contract type is suitable. Nevertheless, at many locations this least favored contract type constitutes a substantial percentage of the workload. A billing system review is not the best place to identify and correct control weaknesses which arise under this contract type. Refer to 6-204.

c. It is quite common for the contract to specify labor categories which do not coincide with the contractor's established labor classifications. Ideally, the contract itself will specify the required skills and experience for each billable labor category. When this is not the case, the contractor's proposed classifications de-

termine the propriety of employee classifications to contract categories by operation of the Order of Precedence clause (FAR 52.215-33). The contractor's labor distribution system should input incurred labor hours by contract category to the billing system, and the controls preventing misclassification of employees should be reviewed as a part of the labor controls. If these controls do not exist, or have not been evaluated, they must be evaluated as a part of the billing system review.

d. In addition to review of the controls affecting cost-reimbursable billings, review of a billing system which processes a significant volume of T&M, labor hour, or FFP/LOE contracts must verify that controls are in place which assure: that billings include only actual labor hours per the labor distribution; that each billed hour is assigned to its proper category; and that categories are billed at the correct contractual rate.

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CHAPTER 7

7-000 SELECTED AREAS OF COST

7-001 Scope of Chapter

This chapter discusses items of cost and accounting methods requiring special attention. The guidance furnished is

oriented toward audit methods and techniques and is not intended as a substitute for, or interpretation of, the Federal Acquisition Regulation.

7-100 Section 1 — Computer Cost Allocation

7-101 Introduction

This section contains guidance for evaluating the accounting for computer programming and reprogramming costs and computer operating costs.

7-102 Allocation of Computer Operating Costs

7-102.1 General Principles

a. DCAA policy requires that where computer costs are material, the FAO audit staff should develop an understanding of computer cost composition and test the contractor's use of the criteria sufficiently to assure that costs are distributed in an equitable manner. If an algorithm is used, and costs distributed are significant, periodic audit evaluation of the algorithm is essential.

b. This coverage addresses a common situation where a contractor has a computer system designed to be responsive to only the internal needs of the organization. Adjustments will have to be made to the audit program to handle the other types of computer system environments which the auditor may encounter. Adjustments should be made on a case by case basis.

c. This section primarily addresses billing algorithms. However, many of our contractors distribute EDP costs through general indirect cost allocations. In those cases auditors must still determine whether methods used to distribute EDP costs are equitable. While algorithms based on resource utilization are generally preferable, an algorithm is not required if indirect cost distribution is equitable.

d. Cost Accounting Standard 418 as related to computer costs provides for consistent determination of direct and indirect costs. It provides criteria for the accumulation of indirect costs including service center and overhead costs in indirect cost pools and provides guidance on selection of allocation measures based on the beneficial or causal relationships between an indirect cost pool and cost objectives. Refer to CAS 418 (8-418) for additional details.

e. Billing algorithms used by contractors to allocate computer costs should be included in a contractor's disclosure statement in order for the disclosure statement to be considered adequate (see 8-206).

7-102.2 Algorithm Development

a. A computer billing algorithm is a mathematical formula used to develop the amount to be charged a customer, contract or overhead pool for services. The formula is based on such factors as type of equipment used, storage media utilization and space allocation, type of processing, response or turnaround time, and time of day services are provided. In a complex EDP environment, a wide range of EDP support is provided to various system users. Developing an algorithm to equitably distribute EDP costs may incorporate all major EDP resources or only a few. The greater the variation in types of application or services provided, the greater the need for a more complex algorithm. The cost of developing a complex algorithm, including subsequent recording of computer use through internal software, is normally compared with the benefit (exactness) of such an algorithm. If it can be demonstrated that an algo-

7-102.2a.

rithm using only two or three resources is equitable, a complex algorithm is not necessary.

b. Resources typically measured and collected for construction of a user charge include:

—Central processor (CPU) time - the amount of CPU time required to accomplish a specific task.

—Computer memory requirements - many algorithms consider the amount of memory (bytes) used for each job.

—Input/output transactions - with the wide range of data input/output devices such as magnetic tape, disks, and terminals, algorithms often consider the number of times such equipment is accessed.

—Direct access storage requirements - tape and disk storage requirements are often considered, including the amount of disk workspace and number of tape devices and/or tape mounts required by each job.

c. Typically, accounting information is collected by operating system software for each user application. In addition, the operating system usually contains provisions for user-supplied routines to collect utilization data. Numerous software vendors have developed specialized software packages to reduce these data and generate a variety of management reports. Such packages often provide time-sequenced resource utilization statistics that can be used to develop billing criteria and make recommendations on improving overall system efficiency.

d. Billing information is usually generated by a billing algorithm. Often the final billing unit is an average resource unit incorporating the various algorithm components. A simple example is shown below:

Resource unit = CPU time × coefficient

+ Memory usage × coefficient

+ Input/output transactions × coefficient

+ Printer time × coefficient

e. The coefficients, which include but are not limited to staff costs, programming costs, and hardware costs, should be evaluated for applicability. Most often, coefficients reflect a ratio between the cost of a specific resource and the total availability of the resource (for

example, cost of CPU divided by total available CPU seconds.)

7-102.3 Audit Objectives in Algorithm Evaluation

When evaluating computer billing algorithms, audit objectives include:

a. Developing an overall understanding of allocation methods used.

b. Verifying that algorithm components accurately represent resources used.

c. Validating that there are sufficient controls to assure that billings are processed in an accurate and reliable manner.

d. Determining whether all applicable costs are included in the development of the coefficients.

e. Validating that the individual rates or coefficients are accurate and properly applied.

f. Testing allocation criteria to assure that computer cost allocations are equitable.

7-102.4 Algorithm Review Techniques

For purposes of algorithm evaluation, a structured audit review approach is suggested as outlined in the following subparagraphs. A billing algorithm summary checklist, as shown in Figure 7-1-1, is often useful to control necessary audit steps.

a. Determine billing formula risk and materiality. If billing algorithms do not distribute a material amount of contract cost (direct and/or indirect), the need for a detailed algorithm review may be obviated.

b. Request contractor support for the billing formula:

(1) Explanation of the algorithm. Generally the contractor should have documented the algorithm. Consideration should be given to any tests (benchmarks) performed to validate the algorithm.

(2) EDP resources used in the algorithm. The contractor should be able to identify which resources have been included in the formula and the rationale, if applicable, for excluding major resources.

(3) Cost distributed during recent periods.

(4) Accounting treatment of variances. This is a critical area as the timing of variance adjustments and accounting treatment can significantly impact costs distributed to contracts.

(5) Current inventory of EDP equipment. This will be valuable when determining whether all appropriate resources are included in the algorithm. In addition, it is essential for adequate equipment maintenance and control that the contractor have detailed visibility of EDP resources.

c. Compare billed EDP costs with actual:

(1) Are procedures established for equitable and timely treatment of identified variances?

(2) If there are significant recent variances, has the algorithm been adjusted for more accurate cost distribution?

(3) Does the contractor compare costs for periodic runs of the same job; for example, payroll? Are significant differences investigated?

(4) Does the contractor make periodic revisions to projected rates as a result of changes in estimated costs or usage of a component?

(5) Are discounted coefficients offered for off-hours usage?

(6) Has an evaluation been made of the contractor's previous projections of computer component rates by comparison of actual rates to projected rates? What are the reasons for significant variances such as unplanned usage or nonusage, or the increase or decrease in costs? If the contractor makes periodic reviews of projected rates, arrange to audit these reviews. If there have been significant variances due to volume differences, per-

haps more frequent reviews should be recommended.

d. Verify major EDP resources. Critical considerations for an algorithm are whether it is based on verifiable usage data, and whether resources used in the algorithm accurately represent services provided system users. Consider whether:

(1) All major resources are included in the algorithm.

(2) Resource usage is based on verifiable data.

(3) Resources are costed appropriately.

(4) Algorithm components are restricted to EDP resources.

(5) Lease agreements for equipment have been considered.

(6) Equipment costs are properly determined for each grouping.

(7) The algorithm includes any unallowable costs, such as excessive rental charges for EDP.

e. Evaluate coefficients and other factors:

(1) Are coefficients based on verifiable data?

(2) If there are outside sales of EDP services, are the services comparable to in-house applications and are they priced comparably to in-house EDP support?

f. Manually compute the billing formula for selected major government projects:

(1) Can the algorithm be computed using verifiable data?

(2) Is the manual calculation reconcilable to the machine output?

(3) Can coefficients and factor utilization be accurately verified?

(4) Are comparisons of items such as the ratio of cost input to EDP billings reasonable?

Figure 7-1-1 (Ref.7-102.4)
BILLING ALGORITHM SUMMARY CHECKLIST

<u>Audit Step</u>	Working Papers		
	<u>Reference</u>	<u>Auditor</u>	<u>Date</u>
1. Risk evaluation			
2. Contractor support			
a. Obtain explanation of algorithm			
b. List EDP resources idn algorithm			
c. List distributed EDP costs by quarter			
d. Identify accounting treatment of variances			
e. Identify EDP policies/procedures for cost treatment			
f. Obtain current inventory of all EDP equipment			
3. Compare billed EDP costs with actual			
a. Variance treatment			
b. Timing of adjustments			
c. Are fixed-price/commercial type variances substantial			
4. Verify EDP inventory (consider sampling techniques)			
a. Purchase agreements			
b. Are major resources in algorithm?			
5. Evaluate coefficients and other factors			
Are coefficients based on verifiable data?			
6. Manually compute billing formula for major government projects			
a. Is it based on available/verifiable data?			
b. Is the manual calculation reconcilable to machine form?			
c. Can coefficients/factors be verified?			
d. Are parity checks such as contribution to cost comparable?			

7-102.5 Billing Algorithm Example

a. When internal measurements are used, billing rates are developed to allocate the cost of each major component on the basis of the component's usage. These billing rates are usually computed annually and are developed by dividing the estimated annual cost associated with each component by the estimated annual usage of the component. The billing may be made in one of two ways: (1) separate billing rate for each component or (2) a single overall rate which is applied to equivalent units of usage for each component.

b. Computer costs can be distributed equitably using a wide range of mathematical techniques. As previously discussed, it is important that a contractor clearly document methods used, and base cost allocations on verifiable cost and utilization data.

c. The example in Figure 7-1-2 includes a five-resource cost allocation. For illustration purposes, one resource-magnetic tape drives-is traced through a weighting factor (coefficient) adjustment and the rate calculation. Coefficients are not essential but are included in many algorithms. Accordingly, a typical coefficient is included in the example.

Figure 7-1-2**BILLING ALGORITHM EXAMPLE**

1. Formula resource components are:

<u>Resource Allocated</u>	<u>Unit of Measure</u>	<u>Charge/ Prime Shift</u>
CPU	CPU hours	\$300/hr
Memory	1024 word block hours	\$5/hr
Disk Channel Time	Channel hours	\$25/hr
Tape Channel Time	Channel hours	\$10/hr
7- and 9-track Tape Drives	Elapsed hours	\$5/hr

2. The coefficient is computed using the following algorithm:

$$\text{CWF} = \frac{\text{Cost } r}{\text{T Cost}} \times \text{Total } r \times \% \text{ used}$$

CWF = computer weighting factor or coefficient to equalize billings.

Cost r = cost of resources being allocated

T Cost = total EDP costs to be allocated

Total r = number of resource units available

% used = percent resources are used

3. If we want to illustrate the weighting factor for tape drive utilization, we can assume the following data was available in contractor records.

Cost r = \$12,500
T Cost = \$3,000,000
total r = 16 tape drives
% used = 70%

4. Substitute into the algorithm:

$$CWF = \frac{12,500}{3,000,000} \times 16 \times 70\% = .046$$

5. After developing an application weighting factor (coefficient), a rate is normally developed for the resource. Again for illustration purposes:

$$\text{Rate} = \frac{\text{Cost r}}{\text{Max r hours}} \times \frac{1}{CWF}$$

6. If contractor records show:

$$\begin{array}{rcl} \text{Cost r} & = & \$12,500 \\ \text{Max r (prime shift) 16 tape drives} & & \\ \text{hours} \times 40 \text{ hrs/wk} \times 52 \text{ wks} & & = 33,280 \\ \text{(second shift) 16 tape drives} & & \\ \times 40 \times 52 \times 50\% \text{ disc} & & \underline{16,640} \\ & & 49,920 \end{array}$$

7. Substituting:

$$\text{Rate} = \frac{\$12,500}{49,920} \times \frac{1}{.046} = \$25 \times 21.7 = \$5.43$$

8. As shown above, manually calculating the rate for tape drives shows an actual rate of \$5.43. If a billing rate of \$5.00/hr is used and utilization forecasts are accurate, tape drive cost will be underabsorbed.

d. As billing algorithms vary widely, this example should not be viewed as typical. However, it does demonstrate potential algorithm complexity. Accordingly, the approach suggested in 7-102.4 provides a framework for developing an audit opinion without evaluating and testing each component of the algorithm. If each factor or algorithm component cannot be verified by historical or current data, risk that costs are unequitably distributed is greatly increased. In such cases, the audit report should recommend that billing algorithms be based on verifiable data and that they include major EDP resources used.

e. In many instances contractors may simplify the billing process. The example below addresses CPU costs only (other resources would be billed similarly), and if estimated CPU utilization is reasonable, billed costs would be equitable.

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Figure 7-1-2

$$\text{Coefficient} = \frac{\text{Cost of CPU for billing period}}{\text{Available CPU seconds for billing period}}$$

Cost of CPU for billing period = \$15,000

Available CPU seconds = 720,000

$$\text{Coefficient} = \frac{\$15,000}{720,000} = \$0.020833$$

Billed amount = \$0.020833 × CPU seconds consumed for each job

7-103 Amortization of Significant Nonrecurring Computer Programming and Reprogramming Costs

7-103.1 General Principles

Equity in accounting for significant nonrecurring costs of computer programming and reprogramming usually requires that such costs be capitalized/amortized. The initial programming costs are incurred in order to place the computer into operation and as such are normally as much a part of the initial costs of the computer as are the equipment installation costs. A major change in either the equipment or the system usually involves the incurrence of significant reprogramming costs. These costs will normally benefit future periods in much the same manner as major modifications of the equipment. On the other hand, established programs are subject to minor refinements and improvements, the costs of which are chargeable to current operations in much the same manner as minor repairs.

7-103.2 Amount to Be Capitalized

The amount of programming or reprogramming costs to be capitalized should represent the actual costs incurred by the contractor in preparing and testing the

program; that is, all applicable direct and indirect costs should be included up to the point the program becomes operational.

7-103.3 Amortization Period

The length of the amortization period should be established on the basis of the estimated number of years that will benefit from the incurrence of the programming or reprogramming costs. As a general rule the period of amortization of those programs for which there appears to be a continuing need should not exceed the anticipated useful life of the computer. A shorter amortization period should be used in those cases where the contractor can demonstrate by historical data or otherwise that the useful life of the program is shorter than that of the computer. At the larger computer centers, where numerous programs may be involved, an averaging of the expected lives of various programs may be acceptable when such procedure results in a reasonable amortization of the related programming costs over the years benefited.

7-103.4 Amortization Method

The method used to amortize the costs over the estimated useful life of the program should be based on the contractor's normal practice applicable to other

items of software. Where this is not possible, any reasonable method of amortizing such costs over the estimated useful life of the program should be considered acceptable particularly if the method is the same as that used for depreciating the equipment.

7-103.5 Justification for Immediate Charging to Current Operations

In some circumstances, the contractor may represent that the desired objective of capitalization/amortization as outlined above is substantially and consistently achieved by charging to current operations all programming and reprogramming costs when and as they are incurred. Due consideration should be given to such representation, provided the contractor submits sufficient data in support of the representation.

7-104 Accounting for Computer Software Costs Under FASB No. 86

7-104.1 Applicability of FASB No. 86

FASB Statement No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," was issued by the Financial Accounting Standards Board in August 1985. It specifies the financial accounting treatment for the costs of computer software sold, leased, or otherwise marketed either as a separate product or as a part of another product or process. It applies both to internally developed and produced software and to purchased software and is applicable for fiscal years beginning after 15 December 1985. For contractors on a calendar year basis, the statement is therefore applicable on 1 January 1986.

7-104.2 Purpose of FASB No. 86

The primary purpose of the statement is to identify the point in time that research and development costs incurred in the process of creating a software product to be sold, leased, or otherwise marketed become production costs which should be capitalized and amortized over future sales. In addition, it specifies amortization, disclosure, and other related requirements.

7-104.3 Limitations of FASB No. 86

The statement does not address the accounting and reporting of costs incurred for computer software created for internal use, or for others under a contractual arrangement. The FASB has stated that it does not consider these issues to be a significant problem in that most companies currently expense these costs. Nonetheless, the criteria for capitalization espoused in the Statement, which are based on the point in time that R&D activities became production activities, may be considered to apply to development of any computer software, whether for sale or for internal use.

7-104.4 Technological Feasibility

FASB 86 provides that costs incurred internally in creating a computer software product are to be charged to expense when they are incurred as research and development until "technological feasibility" has been established for the product. Technological feasibility is established when either (1) the detailed program design has been completed or (2) a working model has been developed. After technological feasibility has been established, all software production costs are to be capitalized and reported on the financial statements at the lower of unamortized cost or net realizable value and are to be amortized based on current and future revenue. Capitalization of software costs shall stop when the product is available for general release to customers.

7-104.5 Audit Considerations

The issues of capitalization of computer software and other related topics are still developing. Battelle ASBCA Case No. 20626 and other legal decisions have concluded that computer software is a tangible capital asset "for tax purposes." For contract costing purposes, costs should be capitalized when there is a foreseeable benefit to future periods or expensed in accordance with GAAP. However, CAS 404 should not be cited as a basis for requiring the capitalization of computer software costs until more definitive guidance is available. Although CAS 404 should not be cited, the ratio-

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nale requiring the capitalization of tangible assets may be considered to be applicable to all assets. Therefore, whether in-house developed software is considered a tangible or intangible asset, the rationale underlying the Cost Accounting Stan-

dards in general and CAS 404 in particular require that costs of computer software developed for internal use be capitalized and amortized over the period benefited.

7-200 Section 2 — Leasing Costs

7-201 Introduction

This section provides guidance for evaluating leasing costs.

7-202 Applicable Contract Regulations

7-202.1 Applicability of FASB Statement 13

Guidance for the treatment of lease costs is covered by Financial Accounting Standards Board (FASB) Statement No. 13, Accounting for Leases. The Statement is effective for leasing transactions and revisions entered into on or after 1 January 1977. For leases in effect on 1 January 1977, FASB Statement 13 was optional until fiscal years beginning on or after 31 December 1980. FASB Statement 13 is incorporated in FAR 31.205-36 (Rental Costs), FAR 31.205-2 (ADPE Leasing Costs), and FAR 31.205-11 (Depreciation).

7-202.2 Applicability of FAR

FAR 31.205-36 applies to the cost of renting or leasing real and personal property, acquired under operating leases (see 7-205, 206) as defined in FASB Statement No. 13. If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) apply (see 7-413).

7-202.3 Applicability of CAS

CAS 404, Capitalization of Tangible Assets, is incorporated in FAR 31.205-11(m). CAS 404 applies to assets acquired by a capital lease as defined by FASB Statement 13. Compliance with FASB Statement 13 and CAS 404 requires that capital leases be treated as purchased assets. The capitalized value of such assets should be distributed over the useful lives of the leased assets as depreciation charges, or over the leased life as amortization charges, as appropriate.

7-203 Capital Leases

If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) and CAS 404 apply (see 7-413 and 7-202).

7-203.1 Main Requirements of FASB Statement 13

a. Criteria for Classification as a Capital Lease

From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used to classify the lease.

(4) The present value, at the beginning of the lease term, of the minimum lease payments (excluding executory costs such as insurance, taxes, etc.) equals or exceeds 90 percent of the excess of the fair value of the leased property over any related investment tax credit retained by the lessor. The 90 percent test should be considered a lower limit rather than a guideline. However, where the lease term begins in the last 25 percent of the estimated economic life, this criterion shall not be used to classify the lease.

b. Determination and Amortization of Minimum Lease Payments

(1) Capital leases should be recorded as assets and liabilities at the lower of the present value of the minimum lease payments at the beginning of the lease term or the fair value of the leased property at the inception date. The discount rate used in determining present value is the lower of the lessee's incremental borrowing rate (the rate the lessee would have incurred to borrow the funds necessary to purchase the asset) or the implicit (lessor's) rate in the lease, if the implicit rate

can be determined. The minimum lease payments are allocated between a reduction of the liability and interest expense to produce a constant periodic interest rate on the remaining balance.

(2) A lessee may use its secured borrowing rate in calculating the present value of minimum lease payments if the rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

(3) Contingent rentals are the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. See 7-204.2 regarding lease payments dependent on economic escalation factors.

c. Calculation of Amortization (Depreciation) for a Capital Asset

The asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets. See 7-400 for a discussion of depreciation costs. The asset shall be amortized over a useful life as follows:

(1) If the leased property reverts to the lessee at the end of the lease or if the lessee is able to purchase the property at a bargain purchase price, then the asset life will be that normally used by the contractor for similar assets.

(2) If the property is leased for a term which is 75 percent or more of the economic life of the asset or the minimum lease payments equal or exceed 90 percent of the fair value of the asset (less applicable credits) then the asset should be amortized over the life of the lease to the value to the lessee, if any, at the end of the lease.

d. Renewals and Terminations

(1) If a capital lease is renewed or extended and the renewal is also classified as a capital lease, the carrying value of the asset may require adjustment. When the capitalized value under the

revised lease and the present balance of the obligation differ, the asset and liability account is adjusted upward or downward to reflect this difference.

(2) If a capital lease is renewed or extended and the renewal is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of the original term, and the renewal or extension period shall be accounted for as an operating lease.

(3) A termination of a capital lease shall be accounted for by removing the asset and obligation with gain or loss recognized for the difference.

(4) The exercise of a lease renewal option contained in a current lease other than those already included in the lease term (as defined by FASB Statement 13) is classified as a new agreement and not a renewal or extension.

7-203.2 Audit Considerations—Capital Leases

a. Proper Classification of Leases

(1) Auditors should use the computer programs which have been developed to assist in determining whether a lease should be classified as an operating lease or a capital lease. The FAS-13 program, for example, is available on diskette or as a subsystem menu option on the DIIS to assist the auditor in determining if a lease has met the "90 percent" criterion for classification as a capital lease (see 7-203.1a(4)).

(2) Auditors should be alert to instances where, to avoid reporting liabilities on their financial statements, contractors may structure their leases, or include assumptions in testing against the FASB Statement 13 criteria, that result in those leases being classified as operating.

(3) When a capital lease is improperly classified as an operating lease, the excess leasing costs should be determined based on criteria for computing the unallowable leasing costs for capital leases. The cost of leased capital assets in excess of the prescribed depreciation charges (7-202.3) should be disapproved under FAR 31.205-11(m). FAR 31.205-20 (Interest and Other Financial Costs) should not be cited as a basis for disapproving the costs.

¶7-203.2a.

(4) Mitigating circumstances involving materiality determinations may exist. For example, leases reclassified as capital leases may result in depreciation during the early years of the leases at amounts higher than the lease payments due to use of accelerated depreciation methods and applied cost of money (COM). The total depreciation and COM under a capital lease may be greater than the total leasing costs. A notice of technical noncompliance with the applicable FAR provisions or CAS standards would be appropriate in that circumstance. The practice may be in non-compliance with FAR 31.205-11 or FAR 31.205-36 or CAS 404, 405, 409, or 414. These regulations and standards should be reviewed for applicability.

b. Unreasonable Lease Costs

If the lease term is substantially shorter than the asset's useful life, the recovery of a high percentage of the fair market value of the asset over the lease term would be indicative of unreasonable rental costs. In this situation, the auditor should determine if the lessor considered and provided adequate residual value at the end of the lease term in accordance with paragraph 5(k) of FASB Statement 13. Reasonable residual value must be considered in computing minimum lease payments in order to attain reasonable lease costs.

c. Amortization Period

The proper classification of a lease according to FASB Statement 13 does not automatically result in acceptable contract cost. For capital leases, consideration should be given to the acceptability of the amortization period in accordance with FASB Statement 13 and CAS 409.

(1) Definition of Lease Term

FASB Statement 13 defines a lease term as the fixed noncancelable term of the lease plus (i) all periods covered by bargain renewal options, (ii) all periods for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt related to the leased property is expected to be in effect, (iv) all periods

covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and (v) all periods representing renewals or extensions of the lease at the lessor's option. However, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable.

(2) Audit Considerations

When a capital lease is to be amortized over the lease term (see 7-203.1c), renewal periods will be included if they meet the criteria specified in the FASB Statement 13 definition of a lease term. This would be an important audit consideration when the renewal is assured through substantial penalties for nonrenewal or a guarantee by the lessee of the lessor's debt. Failure to review the lease term for renewal clauses could significantly distort the amortization charges to current contracts.

7-204 Review of Lease Clauses

7-204.1 Payment of Executory (Occupancy) Cost

Lease clauses regarding payment of executory costs are of particular interest to the auditor. FASB Statement 13 requires executory costs to be excluded when computing minimum lease payments. Executory costs include maintenance, insurance, taxes, and utilities. When the lease clause provides that the lessee pays the executory costs, the lease is referred to as a "net" lease. When the lessor pays these costs, the lease is referred to as a "gross" lease. Since "net" and "gross" are not universally defined, the auditor should review the lease clause to determine exactly what costs are to be paid by the lessee.

7-204.2 Escalation Lease Clauses

Auditors should be particularly interested in escalation lease clauses. Recently, clauses containing a provision for increasing lease payments based on the Consumer Price Index (CPI) or some other economic indicator have become common. The increase could be subject to adjustment on an annual basis or when an option is exercised. The escalation

may also apply to the purchase price if the lease contains a purchase option.

a. Computation of Minimum Lease Payments

The decision to include or exclude the escalation for purposes of computing minimum lease payments depends on the specific circumstances, and would include:

(1) the factor(s) to which the escalation applies, such as executory costs (which would not be included at all), principal payments, or insurance only;

(2) the factor on which the escalation is computed, such as the CPI or prime interest rate,

(3) the period to which the escalation applies, such as annually, only for an option period, or the incurrence of some period of time, and

(4) the current pronouncements of the Financial Accounting Standards Board.

b. CPI or Prime Interest Rate

Lease payments that depend on an existing index or rate, such as the CPI or prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease. Any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and are excluded from the minimum lease payments (see 7-203.1b(2)).

7-205 Operating Leases for Other Than EDPE

7-205.1 Definition of Operating Lease

Under the provisions of FASB Statement 13, an operating lease is any lease that is not a capital lease.

7-205.2 Criteria for Allowability

For contract costing purposes, a different cost principle applies to EDPE leases than for all other operating leases (see 7-206). The provisions of FAR 31.205-36 apply to all operating leases that do not involve EDPE. The main criterion for allowability of operating lease costs is reasonableness. The cost principle states several criteria that should be considered when making a determination of reasonableness. The provisions in FAR 31.201-

3 should also be used in evaluating reasonableness of operating lease cost.

7-205.3 Audit Procedures

a. Comparison with Comparable Property

Included in these criteria is a comparison with comparable property. The auditor must exercise care when determining what is comparable property. To be comparable, the property must be of the same basic age, size, life expectancy, and location. In addition, the lease provisions must also be comparable. Since there are several clauses which can increase time lease costs (see 7-204), the auditor must ascertain what costs truly are included in the comparable property comparison.

b. Determination of Reasonableness

(1) An audit step in testing reasonableness under FAR 31.201-3 is to review the results of applying FASB Statement 13 capitalization criteria. This is especially critical when reviewing the results of the application of the fourth criteria of FASB Statement 13 (7-203.1a(4)). Auditors should determine whether the lease term is substantially less than the asset life, and whether the present value of the minimum lease payments is significant as compared to the fair market value of the leased property (for example, greater than 50 percent but less than 90 percent). If this condition exists, there is a strong indication that lease costs are unreasonably high and the audit scope should be expanded.

(2) Auditors should be alert to computer programs available from DCAA, the contractor, or other sources to assist them in determining reasonableness. One such program is DCAA's LVPA program, available on diskette or as a subsystem menu option on the DIIS. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis.

7-206 Leased EDPE

The acronym EDPE stands for electronic data processing equipment. Its use in this section is intended to be synonymous with the FAR expression ADPE

which stands for automatic data processing equipment.

7-206.1 General

a. Capital Leases

All leased EDPE is subject to the provisions of FASB Statement 13. For those leases determined to be capital leases per FASB Statement 13, the auditor should use 7-203 above as guidance to evaluate the contractor's method and classification.

b. Operating Leases

Operating leases for EDPE are governed by the provisions of FASB Statement 13 and FAR 31.205-2. Generally, lease costs for operating leases must result in less cost to the government than ownership costs. The contractor is required to submit annually documentation to support its decision to lease rather than purchase EDPE. The following paragraphs should be used to evaluate operating lease costs.

7-206.2 FAR Requirements for Annual Documentation of Leased EDPE

a. Documentation of Contractor's Leasing Decision

The contractor is required by FAR 31.205-2 and DFARS 239.7300 to document its leasing decision with specific types of information which are basic to the determination of the amount of allowable EDPE leasing costs. Where such supporting data are requested but are not furnished by the contractor, the auditor should discuss the matter with the ACO and reach agreement on the action to be taken. Such agreement may include suspension of the related leasing costs pending receipt of the data. In evaluating the quality of the contractor's submitted data, due consideration should be given to any difficulties normally inherent in providing back-up for projected constructive ownership costs. Where the auditor requires additional information it should be obtained preferably from the contractor and/or the contractor's records although pertinent data available from other sources may also be used occasionally. In addition, the requirements of DFARS 239.7300 also apply to purchased EDPE.

b. Ownership vs. Rental Comparison

(1) The contractor's submission to support the allowability of its EDPE leasing costs will generally be in the form of a comparison of constructive ownership costs with leasing costs over the anticipated useful life of the property. The major factors involved in this comparison are: constructive acquisition costs, estimated useful life, depreciation method, residual value, and leasing costs. These factors are discussed in 7-206.4 and 7-206.5.

(2) The auditor should carefully review all pertinent factual data and estimates included in the comparison for propriety and reasonableness. Technical assistance should be obtained as necessary. The determination of whether leasing costs are more costly than ownership costs will be based upon a comparison of the respective amounts for the total estimated useful life of the property. Where this comparison shows leasing costs to be more costly, the amount of leasing costs to be disapproved in any individual year will be the excess of the cumulative leasing costs incurred through that particular year as compared with the cumulative constructive ownership costs which would have been incurred during that same total period.

(3) When comparing ownership and rental costs, auditors should use DCAA's LVPA program. This program is available to FAOs on diskette or as a subsystem menu option on the DIIS. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis. Besides creating a data file and running the program, the options of the LVPA program enable the auditor to (a) modify and print the data file, (b) modify and print a cost-of-money file, and (c) display and print the program documentation.

c. EDPE Annual Submissions

FAR 31.205-2(b)(2) provides that costs of leasing EDPE are allowable only to the extent that the contractor can demonstrate annually that leasing is in the best interests of the government. The key word here is "annually" and this requirement applies particularly in those situa-

tions where the contractor has previously demonstrated that leasing is less costly than ownership. Annual reviews do not, however, apply where it has previously demonstrated that the EDP equipment is cheaper to purchase. The annual justification should recognize all new conditions such as changes in leasing arrangements, anticipated equipment acquisitions, adjustments to useful lives, and changes in residual lives. Also, it should be submitted irrespective of whether the term of the lease was renewed or otherwise extended by the contractor. For equipment already in service, the purchase price to be used in the comparison is the purchase option price under the terms of the existing lease contract, or if an option is not available, then the price in the open market. Also see DFARS 239.7303 for additional requirements regarding the review and approval of leasing costs.

7-206.3 Guidelines for Review of Annual EDPE Leasing Documentation

a. EDPE Offsets

In estimating the comparative costs to the government, as required by FAR 31.205-2(c)(3), the proper procedure is to consider each item of EDPE separately. That is, these costs cannot be determined by offsetting the results of lease advantage and purchase advantage as one net total. The auditor's acceptance or nonacceptance of EDPE leasing as well as the computation of cost disapprovals must therefore be determined on a component-by-component basis. There may, however, be situations where the contractor can show that the lease or buy costs used in the study only apply as a package arrangement with one vendor for two or more closely related components (for example, central processing unit and console), and that such arrangement is in the government's interests.

b. Lease Renewals

Where leasing has been accepted as less costly over the lease period, renewal of the lease will require a new comparison of EDPE lease/ownership costs for the renewal period, on the basis of

(1) the price at which the equipment could be purchased in its condition and

(2) its anticipated remaining useful life, at the lease renewal date. However, a new comparison of leasing versus ownership costs will not be required upon renewal of a lease under which it was previously determined that allowable costs were to be limited to constructive ownership costs. In such case the lease/ownership costs to the date of renewal will require only an updating to cover the renewal period. In regard to EDPE the requirements of this subparagraph are over and above the regular annual submission discussed in 7-206.2.

c. Month-to-Month Rentals

The lease period of an open-end, month-to-month rental arrangement shall be considered to cover the entire useful life of the rented property.

d. Audit Review Using Computer Programs

Auditors should be alert to computer programs available from DCAA, the contractor, or other sources to assist them in determining reasonableness. One such program is DCAA's LVPA program, available on diskette or as a subsystem menu option on the DIIS. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis. Questions regarding this program should be directed to the Technical Services Center.

7-206.4 Constructive Ownership Costs for Leased EDPE

Depreciation will probably represent the largest item of constructive ownership cost; other items comprising ownership cost are stated in FAR 31.205-2(c)(3). Proper projection of depreciation cost will require a determination of (1) the constructive cost of the leased property, (2) its anticipated useful life, (3) its residual value, and (4) the appropriate method of depreciation. Major audit emphasis should be directed to the review of these elements. Additional sources of information include Chapter 8-409 of this manual relative to the Cost Accounting Standard on depreciation, and DCAAP 7641.73, Guidelines for Operations Audits of Automatic Data Processing Systems.

7-206.4a.**a. Constructive Acquisition Cost for Leased EDPE**

The constructive cost of the leased property other than EDPE should be the price at which it could be acquired in its condition on the date the leasing agreement becomes subject to the ownership cost limitation. For EDPE, except as in 7-206.2c, it would be the price on the date it was initially acquired. In any specific case, the determination of such constructive cost may appropriately involve consideration of published purchase prices, fair market value data, independent appraisals, constructive book values, purchase option prices in the lease agreement, or other similar information.

b. Constructive Useful Life for Leased EDPE**(1) General Principles for Constructive Useful Life**

Anticipated useful life is classified in FAR 31.205-2(c)(1) into "application life," or "technological life," or "physical life." This subparagraph also defines the terms and establishes criteria for use of the former two. Where the contractor estimates a useful life period on the basis of application or technological life, it is expected to demonstrate clearly the circumstances and conditions which support the adoption of such short useful life period. While there may be several valid arguments favoring longer use of leased property, when the contractor has clearly demonstrated that the circumstances and conditions support the adoption of a shorter useful life period there will generally be no need to extend the retention period indicated by the contractor, provided that appropriate residual values are established.

(2) Untimely Replacement of Leased EDPE

FAR 31.205-2(c)(2) further provides that "technological advances per se will not justify replacement of existing facilities . . . if such existing facilities will be able to satisfy future requirements or demands." Thus, where a contractor replaces leased facilities before the expiration of their useful life and it is concluded that the replacement was not necessary to satisfy future requirements or demands, any increased costs related to the replacement are not allowable.

(3) Changes in Retention Period of Leased EDPE

The contractor may decide that leased EDPE will be retained beyond the expiration of its useful life as initially estimated in accordance with FAR 31.205-2(c)(1). The constructive net book value of the leased property (less appropriate residual value) at the date the change is decided upon or becomes known should be spread over the extended retention period.

c. Constructive Residual Value for Leased EDPE

(1) The residual value of the EDPE should be the net estimated amount which would be realized upon its sale, at the end of its anticipated useful life as determined in 7-206.4b. above, had the contractor owned the property. A nominal or zero salvage value is not acceptable where the property may actually have a substantial resale value. Junk or scrap value should be used only where the property is calculated to be useful for its entire physical life.

(2) Residual value will of course be related to useful life as determined in 7-206.4b above. Both factors will require concurrent consideration. Amounts to be used for these purposes must necessarily be estimated from trade data available at the time the decision is made to execute or renew a lease.

(3) Agreements often provide purchase option prices which, while in most cases higher than could be realized by contractor sale to a third party, may be indicative of the general magnitude which residual value may approach.

(4) The residual value should be adjusted for estimated selling, shipping, and other disposal costs.

d. Constructive Depreciation Method for Leased EDPE

A depreciation method should be established in accordance with the method which the contractor would have used for cost (book and statement) accounting purposes had it owned the property. In that connection, note the conditions in FAR 31.205-11 on the use of accelerated depreciation methods. There may be instances where cumulative constructive ownership cost exceeds cumulative rental cost during the early years of the useful

life of leased property, although total rental cost exceeds total depreciation and other ownership cost for the entire useful life. In such cases, the excess cost will become questionable in later years of the asset life. This condition should be explained to the contracting officer in the audit report for the fiscal year during which the leasing decision is made, together with a recommendation that she or he advise the contractor that the excess cost will become questionable in later years of the asset life.

7-206.5 Other Considerations on Lease vs. Purchase Comparisons for EDPE

a. Change in Retention Period or Updated Data

Annual depreciation costs on the basis of the originally established constructive acquisition price and useful life of the EDPE will remain unchanged unless there is a change in the retention period. However, other constructive annual and cumulative ownership costs (for example, maintenance or insurance) may require adjustment on the basis of updated information.

b. Changes in Rental or Service Rates

The lease contract should also be examined concurrently for any changes in rental or service rates.

c. Cost of Money

Another consideration is facilities cost of capital that would be claimed by the contractor for owned assets.

7-207 Leases Between Related Parties

Leases between related parties are governed by FASB Statement 13 and FAR 31.205-2(b)(4), EDPE leasing costs, FAR 31.205-11(m)(2), Depreciation, and FAR 31.205-36(b)(3), Rental costs.

7-207.1 Capital Leases

a. FASB Statement 13 and FAR Requirements

Capital leases between related parties is discussed in FAR 31.205-11(m)(2) and FASB Statement 13 (FAS-13), paragraph 5a. If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, costs shall not be allowed in

excess of those which would have been incurred if the lease contained terms consistent with those found in a lease between unrelated parties.

b. Audit Procedures

The auditor should test for reasonableness of rental costs by comparing the present value of lease payments with the fair market value prior to applying the provisions of FASB Statement 13. If the present value substantially exceeds the fair market value, the economic substance of the transaction should be recognized over the "legal form" (see FAR 31.205-11(m)(2) and FASB Statement 13, paragraph 29). Consequently, costs should be questioned to the extent of unreasonableness due to lack of an "arms length bargaining" (FAR 31.201-3(b)). FASB Statement 13 criteria should then be applied in establishing the appropriate treatment for the balance of the costs.

7-207.2 Operating Leases

a. General

Leasing costs between divisions, subsidiaries, or organizations under common control for EDPE and other operating leases are generally allowable to the extent that costs do not exceed the normal costs of ownership (excluding interest or other costs unallowable and including cost of money). To help analyze the lease versus ownership costs, auditors should use DCAA's LVPA program. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis. It is available to FAOs on diskette or as a subsystem menu option on the DIIS.

b. Common Control

FAR does not specifically define common control. ASBCA decisions on common control have emphasized the existence or lack of existence of actual common control. FAS 57 defines control as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." The question of whether two entities are under common control is a question of fact. The key question is whether or not one party has the ability

¶7-207.2b.

to exercise control over the operating and financial policies of the related party. A party may have actual control even if such control is not evidenced by the agreement. Therefore, it is imperative to review the events and transactions that actually occurred in making a determination of whether or not control exists. Two of the most important areas to review are (1) the actual decision making process, and (2) the reasonableness of the lease terms.

(1) A review of the joint venture decision making process is important to determine if control actually exists. For example, if it appears that one company is making practically all the decisions (e.g. the other party is not present at decision making meetings, or if present rarely provides input), this would be an indication that this company is controlling the joint venture. In reviewing supporting documentation, the auditor should remember that percentage of ownership is only one factor to be considered. It is possible that common control will exist even where the controlling individuals own a small percentage of the company's equity. Other factors to consider include, but are not limited to, interlocking management/ownership, identity of interests among family members, shared facilities and equipment, and common use of employees.

(2) The existence of unreasonable lease terms may also provide evidence of control. If the lease terms are unreasonable as compared to those available in the competitive market, it may be because one company has exercised significant influence over the operating and financial policies of the joint venture. Reasonableness may be reviewed by comparing the terms of the lease with (a) the contractor's other comparable leases that did not involve a related party, (b) other comparable leases, and (c) actual advertised prices for the facilities in question or other similar facilities. Both the rates (cost per square foot for example) and other terms (such as fixed noncancellable leases versus those with options) must be considered in determining the reason-

ableness of the lease costs. While showing that the lease costs are unreasonable will not in itself constitute a determination of common control, it is an important factor in making such a determination. In addition, if the government is unable to prevail in its common control argument, it nevertheless should prevail in proving that the lease costs were unreasonable at the time of the lease decision under the provisions of FAR 31.205-36(b)(1).

c. Same or Similar Equipment Leased to Unaffiliated Lessees

Where the same or similar personal property is leased to unaffiliated lessees, other FAR provisions are used to determine the allowability of leasing costs.

(1) EDPE operating leases are subject to FAR 31.205-2(b)(1) and (2), except that the purchase price and costs of ownership shall be determined under 31.205-26(e).

(2) Other operating leases are subject to FAR 31.205-11(b)(1).

7-208 Sale and Leaseback Transactions

a. Leasing costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed had the contractor retained title. Sale and leaseback transactions are governed by FASB Statement 13 and FAR 31.205-2(b)(3), EDPE leasing costs, FAR 31.205-11(m)(1), Depreciation, and FAR 31.205-36(b)(2), Rental costs.

b. A gain from the sale of a depreciable asset that is simultaneously leased back under the type of arrangement covered by FAR 31.205-36(b)(2) should not be recognized as a credit to overhead in the year in which the arrangement was transacted. The allowable lease costs under such an arrangement are limited to the depreciation expense that would have been charged for the same period as if the sale/leaseback arrangement had never been transacted. If at the time of actual disposition of the leased asset, there continues to be a gain or loss associated with the asset, this gain or loss should be recognized.

7-300 Section 3 — Allocation of Special Facilities Operating Costs**7-301 Introduction**

a. This paragraph provides guidance on the treatment of the operating costs of certain facilities, which, if not properly accounted for, could fail significantly to measure the benefits accruing to the several cost objectives.

b. The guidance includes (1) definition of applicable facilities, (2) criteria for determining whether the contractor is using an acceptable basis for charging or distributing costs to work benefited, and (3) criteria for determining billing or costing rates. Allocation of computer operating costs is covered in 7-100.

c. In the course of implementing the following guidelines, including the development of any recommendation to change an established and previously acceptable accounting procedure with respect to a particular facility, the principles below are not to be applied so rigidly as to complicate unduly the allocation where substantially the same results are achieved through less precise methods.

7-302 Criteria for "Special Facilities"

Facilities to which this guidance is applicable cannot be specifically designated by name or type but rather must be determined by whether or not they meet certain basic criteria. The first criterion to be met is that the costs involved in the operation of each facility must be significant in amount with respect to the contractor's overall operations. The second criterion is that the facility benefits only a limited portion of the contractor's total workload. Wind tunnels and space chambers are representative of facilities which, if they meet the criteria above, would be subject to the guidance provided in this section.

7-303 Basis for Allocating Costs to Benefiting Work

There are three basic methods for allocating costs related to facilities which meet the criteria in 7-302, although varia-

tions may be encountered. If a variation appears to reasonably measure the benefits accruing to the several cost objectives, its use should be satisfactory. The three basic methods are described below.

7-303.1 Method 1 — Full Costing on Usage Basis

Under the first method, all readily identifiable direct costs are charged to projects, contracts, or other work involved. Additionally, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages, are allocated to the using projects, contracts, or other work involved, on a usage or other quantitative basis. Generally, this method yields the most equitable results and should be used if cost and usage data for the facility can be economically accumulated with reasonable accuracy. If it is determined that use of methods 2 or 3 below would yield inequitable cost allocations, cost data which will permit the determination of costs by method 1 should be maintained by the contractor.

7-303.2 Method 2 — Only Directly Identifiable Costs Allocated on Usage Basis

Under the second method, readily identifiable direct costs are charged to the projects, contracts, or other work involved, as in method 1 above. However, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages are included in the distribution through one of the contractor's appropriate categories of indirect expense. Although this method is less precise than method 1, its use is satisfactory if it reasonably measures the benefits accruing to the several cost objectives.

7-303.3 Method 3 — General Indirect Cost Allocation

Under the third method, all costs associated with the facility, including direct

labor and material, are grouped and distributed through one of the contractor's appropriate categories of indirect expense. This method should be used only when the contractor demonstrates that (1) neither method 1 nor 2 above is practical and (2) its use is unlikely to result in any significant failure to measure the benefits accruing to the several cost objectives.

7-304 Treatment of Microelectronic Center (MEC) Costs

a. On 8 January 1990, the Acting Under Secretary of Defense for Acquisition (USD(A)) issued guidance concerning the treatment of MEC costs. This USD(A) guidance provides that "The costs of developing and deploying new or improved systems, processes, methods, equipment, tools and techniques to produce the next-generation microelectronics needed for future weapons systems are allowable in accordance with Federal Acquisition Regulation (FAR) 31.205-25, and should be allocated over an appropriate business base in accordance with FAR 31.201-4(c), until such time as the MEC is being substantially utilized for actual production efforts."

b. The Office of Defense Procurement (ODP) generally classifies MECs as special facilities, and therefore CAS 418 is not applicable to MECs. The MEC facility at a specific contractor may not qualify as a "special facility." For example, if the activities performed by the MEC facility are functionally identical to current engineering and manufacturing activities, the facility may not be "special" in nature. CAS 418 noncompliance reports must include an explanation as to why the particular MEC in question does not qualify as a "special facility."

c. Usually, the number of actual units produced by an MEC facility during the development phase will be small, but will increase gradually as the contractor approaches normal production levels. As a result, if the costs of facilities or equipment incurred at the smaller production level are allocated in total to the units produced, an inordinate amount of costs would be allocated to these units during the development period. Development

efforts, when completed, will provide a broader applicability than the utilization in current production represents. Thus, the portion of these costs that represent development efforts should be allocated over a broader business base until the MEC facility approaches anticipated normal and/or substantial production levels, i.e., until the facility achieves self-sufficiency. Any such allocation of development costs should be done on an objective basis.

d. One of the key factors to consider in reviewing MEC costs is the basis used for distinguishing the production efforts from the development efforts. Whatever basis is used, it should be objective in nature to assure that allocations are based upon benefits received and that a broad business base allocation is applied to the development costs only until such time as the facility becomes self-sufficient. For example, an objective basis could include an allocation of total MEC costs based upon the proportion of production effort to development effort. In other circumstances, it may be possible to identify the specific functions associated with production and those associated with development, with an allocation of costs made accordingly.

7-305 Determination of Costing Rates

7-305.1 Basic Procedures for Costing Rates

a. General operating costs of those facilities which meet the criteria in 7-302 and for which method 1 above is considered appropriate should generally be charged to users by means of actual or predetermined billing or costing rates as provided below. This will require maintenance of a time log for each facility to record the hours of time spent by each user. The period covered by the billing or costing rates will not normally exceed 12 months. See 8-406 for CAS-covered contractors and FAR 31.203(e) for non-CAS-covered contractors.

b. When only one rate for the facility is to be applied, it should consist of the actual or estimated applicable costs divided by the actual or estimated number

of hours or other units composing the basis.

7-305.2 Treatment of Real and Estimated Cost Differentials

a. When real cost differentials (such as certain services furnished during prime shifts only or by different facilities) exist and can be readily demonstrated, separate rates for such cost differentials may be used.

b. In the case of educational institutions, when rental or lease costs are based upon prime-shift usage, second and third shift usage may, with appropriate approval, be charged at reduced rates.

c. Under certain situations, reasonably estimated differential costs may be used in instances where cost differentials logically exist but cannot be determined precisely by contractor. For example, such differentials would permit priority, interrupt, or short-turnaround time runs at premium rates and/or nonpriority, non-prime-time, or large-volume runs at reduced rates.

d. Whether a single rate or several rates are used, the rates should be so designed as to recover, or closely approximate total recovery of, costs from all users of the facility. Where differing rates are used, they should be applied to all users on a nondiscriminatory basis. The cost-

ing of accommodations sales at reduced rates is not considered appropriate.

7-305.3 Treatment of Under- or Overabsorbed Rates

Any immaterial under- or overabsorption of costs resulting from application of predetermined rates may be charged or credited to an appropriate category of indirect expense. If the under- or overabsorption is material, it should be treated in accordance with the CAS-covered contractor's disclosed practices (see 8-418).

7-306 Treatment of Manufacturer Discounts to Educational Institutions

When the manufacturer leases or sells the equipment below commercial prices to an educational institution as an allowance to education, the allowance should be treated as a reduction of the cost of leasing or purchasing.

7-307 Treatment of Grants for Special Facilities

When the contractor (usually a university) has received a grant from the government to be used in connection with a particular facility, application of the funds provided should be in accordance with the terms of the grant.

7-400 Section 4 — Depreciation Costs

7-401 Introduction

This section contains guidance on depreciation costs under research and supply contracts with commercial organizations. The guidance in this section covers only the FAR provisions regarding depreciation costs.

7-402 Contract Provisions on Depreciation

7-402.1 General Applicability of FAR and CAS

a. The provisions of FAR 31.205-11 govern the allowability of depreciation costs. Contractors with contracts subject to cost accounting standards (CAS) must comply with the provisions of CAS 409, Depreciation of Tangible Capital Assets, and CAS 404, Capitalization of Tangible Assets. CAS 404 and CAS 409 are incorporated into FAR Part 31.

(1) CAS-covered contractors may elect to comply with CAS 409 on their contract(s) not subject to CAS 409. Contractors electing to comply with CAS 409 on their non-CAS covered contracts must comply with all provisions of the standard.

(2) In some cases the provisions of FAR 31.205-11 may conflict with the provisions of CAS 409. When CAS 409 is applicable, its provisions supersede any conflicting provisions of FAR 31.205-11.

b. Guidance on the cost accounting standards is in chapter 8 and will not be repeated here. Auditors should refer to chapter 8 for guidance on reviewing depreciation costs on CAS covered contracts.

c. Guidance in the application of the FAR provisions is presented below.

7-402.2 General Allowability Criteria of FAR

Normal depreciation is generally considered allowable contract costs if reasonable and allocable.

a. Depreciation Same For Both Financial and Income Tax Purposes

(1) For non CAS covered contracts under FAR 31.205-11(d), costs are rea-

sonable if the contractor follows policies and procedures that are (1) consistent with those followed in the same cost center for business other than government, (2) reflected in the contractor's books of accounts and financial statements, and (3) both used and accepted for Federal income tax purposes.

(2) However, due to unusual circumstances affecting defense contracts, the contractor's policies and procedures may result in inequitable charges to the government. If any inequities are found, Headquarters should be advised.

b. Depreciation For Financial Purposes Differs From Income Tax Purposes

(1) If a contractor subject to FAR 31.205-11 rather than CAS 409 does not use the same policies and procedures for financial/book purposes and Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years-digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-government business (FAR 31.205-11(e)).

(2) However, if the amounts used for book and statement purposes are not reasonable or equitable for contract cost purposes, costs should be questioned.

7-402.3 Relationship Between FAR and IRS Regulations on Depreciation

a. Tax Methods versus Financial Statement Methods of Depreciation

(1) In 1986 changes were made in the Internal Revenue Code and implementing regulations to permit the use of accelerated methods of depreciation in determining taxable income. Since that time many companies have adopted these methods for income tax purposes in order to defer payment of taxes and to improve cash flow, while for book and financial statement purposes they continue to use the traditional straight-line

method of depreciation. Thus, the amount of depreciation charged to operations under the contractor's established depreciation policies and procedures may often differ from the amount claimed for Federal income tax purposes.

(2) The FAR cost principles applicable to non CAS covered contracts recognize this situation by providing that, where the contractor uses the same method for book and tax purposes, the auditor will be guided by the provisions of FAR 31.205-11(d), which incorporate by reference certain criteria in the Internal Revenue Code. On the other hand, where the book and tax methods differ, the amount allowable for the fiscal period for contract cost purposes is determined on the basis outlined in FAR 31.205-11(e) and may not exceed the book/statement amount.

b. Contract Audit Responsibility Related to IRS Reviews of Depreciation

(1) The Internal Revenue Service regulations which implement Section 167 of the Internal Revenue Code of 1954, as amended, prescribe detailed criteria for determining depreciation costs. These criteria are intended to be understood and applied not only by IRS personnel but also by businessmen as well as professional accountants and auditors so as to obtain substantially the same results. FAR 31.205-11(d)(3) should therefore not be construed nor was it intended to require defense procurement or audit personnel to wait for IRS post audit approval (or disapproval) of an income tax return before the amount of allowable depreciation costs is determined for contract cost purposes.

(2) DCAA auditors should therefore acquire and maintain a working knowledge of the IRS code and regulations on depreciation. It should also be noted in this regard that the taxpayer (contractor) can enter into a written agreement with the IRS in advance of filing its tax return to determine the tax liability on any unusual situation which it does not consider sufficiently covered in the IRS regulations. The auditor should be aware of any such agreement.

7-403 General Audit Review Techniques for Depreciation

7-403.1 Review of Contractor Depreciation Records

A proper determination of periodic depreciation costs depends largely on the effectiveness and consistency of the contractor's depreciation policies and procedures and on the sufficiency of the related property/depreciation records. Because an interrelationship exists between the amount of depreciation cost chargeable to any fiscal period as compared with prior and/or future fiscal periods, completeness of such records for the entire retention period of the asset(s) is essential. In making an audit review of these records, the following considerations warrant special attention.

7-403.2 Review of Contractor Depreciation Policies and Procedures

The auditor should review the contractor's depreciation policies and procedures and perform selective tests to determine whether the policies and procedures have been followed to calculate depreciation for the accounting period being reviewed.

7-403.3 Review of Asset Cost

The auditor should determine if the capitalized asset cost, including any cost of making the asset ready for use, is supported by the contractor's accounting records. This may include verifying the cost of the asset to supporting documents such as purchase order, vendor invoice, and cancelled checks. It may also include reviewing the cost of betterments, as well as determining if asset retirements have been properly accounted for.

7-403.4 Review of Contractor's Schedule M and IRS Audit Reports

The examination should also include a review of Schedule M of the contractor's Federal income tax return and the results of any review of the tax returns made by the Internal Revenue Service. In the event the IRS has made any changes, the auditor should evaluate the amounts and circumstances and make whatever adjustments are appropriate to determine al-

allowable depreciation costs of the current or prior years. The review of Schedule M will indicate whether the contractor's method of computing depreciation for tax purposes differs from that used for book and statement purposes. This is important since the criteria in FAR 31.205-11(e) which applies to contracts that are not covered by CFR 9904.409, states that if the amounts differ, allowable depreciation shall not exceed the amounts used for accounting books and financial statement purposes.

7-403.5 Review of Contractor Financial Statements

The contractor's financial statements should reflect the amount of depreciation charged to operations on the contractor's books. Financial statements are considered to be those statements which are annually certified and distributed to stockholders and others. Since such statements generally cover company-wide operations, the FAO responsible for the audit of the home office should serve as the focal point for assistance to other field audit cognizance.

7-404 Special Considerations— Depreciation Charged to Government Contracts

The fact that the contractor's overall book and statement depreciation is also used for Federal income tax purposes, and is acceptable for such purposes, does not necessarily mean that the depreciation charged to defense contracts is acceptable.

7-404.1 Allocation of Depreciation

Depreciation should usually be allocated to the contract or other work as an indirect cost.

a. Identification to Organizational Units

Depreciation should preferably be determined and recorded for each department, cost center, or similar organizational segment, so that the cost is identified as closely as possible with the benefiting work or activity. Where plant or company-wide rates are being used, the auditor should make sufficient tests to

determine that the end results are substantially the same as would be achieved by relating depreciation to government contracts by more refined methods.

b. Inequities of Company or Plant-wide Basis

Allocation of depreciation on a plant-wide basis may not be equitable, for example, where the government work is being performed in only part of the facilities, or where the contractor is replacing assets in the plant areas performing primarily commercial work more rapidly than in the segments engaged in defense work.

c. Reporting Requirements

Where the auditor determines that the contractor's use of plant or company-wide rates does not currently result in an inequitable cost allocation, the auditor may consider it necessary to formally notify the contractor that if the cost pattern or nature of the work changes so as to result in inequitable charges against government contracts, the method will no longer be acceptable.

7-404.2 Depreciation Methods for Commercial Versus Government Work

In any given cost center, various classes of assets may be depreciated under more than one method. If so, the auditor should ascertain that the depreciation methods do not vary between assets used for commercial products and those used for government work so as to result in discrimination against government contracts.

7-404.3 Depreciation on Assets Acquired from the Government and Depreciation of Fully Depreciated Assets

a. Determine whether the contractor has claimed depreciation on those types of property described in FAR paragraphs 31.205-11(j) and (l). These paragraphs relate principally to assets acquired from the government at no cost to the contractor and fully depreciated assets.

b. Usage charges for fully depreciated assets are permitted under certain circumstances. FAR 31.205-11(l) states that "... a reasonable charge for using fully depreciated property may be agreed upon and allowed." A usage charge may be appropriate when the actual useful life of

an asset exceeds its estimated useful life and there has been a significant change in government participation after the asset was fully depreciated. In such cases, the allocation of the cost of the asset usage between government and commercial contracts may be adjusted by applying a usage charge.

c. In reviewing contractor claims for usage charges, it is imperative that the auditor determine if the actual useful life of the asset exceeds the estimated useful life due to a betterment, an error in estimate, or a patchwork repair.

(1) Betterment. CAS 404-40(d) states that "Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g. betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized . . ." Accordingly, in those cases where the useful life of the asset extends beyond its estimated life as a result of a betterment, CAS requires that the contractor adjust the estimated life of the asset. If the contractor has failed to make such an adjustment, then the asset is not fully depreciated and the usage charge should be disallowed.

(2) Error in Estimate. On a few occasions, the contractor may have an asset that lasts longer than its estimated useful life as a result of an error in the contractor's original estimate. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, when the actual useful lives of the contractor's assets exceed the estimated useful lives on a recurring basis, the auditor should review the contractor's estimating procedures to assure that they comply with the requirements of CAS 409. If the assets are fully depreciated as a result of a

noncompliance with CAS 409, the usage charge should be disallowed.

(3) Patchwork Repair. On rare occasions, a contractor may decide to continue to utilize an asset beyond its useful life through continual patchwork repairs. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, the auditor should review the contractor's rationale for continually repairing the asset rather than overhauling the asset (a betterment), trading in the asset, or scrapping the asset in favor of a new one. The auditor should consider factors such as the cost of patchwork repairs, the utilization of contractor personnel in performing these repairs, the cost of an overhaul, the trade-in value of the old asset, and the cost of a new asset.

d. Approval and Computation of Usage Charge.

(1) When the continued use of a fully depreciated asset is appropriate under the circumstances, FAR 31.205-11(l) provides that the allowability of a usage charge is subject to the approval of the contracting officer. While usage charges are permitted under the FAR, there is no requirement that the contracting officer allow the charges.

(2) When a usage charge is allowed, the amount of the charge should be determined on a case-by-case basis. In determining a reasonable usage charge, the auditor should make sure that the contractor has properly considered each of the factors listed in FAR 31.205-11(l), including the cost, estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to government contracts or subcontracts. To demonstrate how a reasonable usage charge may be calculated, an example is shown below:

Cost of asset	\$100,000
Original Estimated Useful Life	3 years
Actual Useful Life	5 years
Total estimated decrease in efficiency for Years 4 and 5 (\$2,000 per year)	\$4,000
Total estimated increase in maintenance (patchwork repairs) for Years 4 and 5 (\$2,500 per year)	\$5,000

7-404.3d.

Average Government Participation for Years 1 through 3	50%
Average Government Participation for Years 4 and 5	90%

Calculation of Recommended Usage Charge:

Depreciation expense charged to the government if the estimated useful life had been 5 years:

Years 1 thru 3 (\$20,000 per year × 3 years × 50%)	\$30,000
Years 4 and 5 (\$20,000 per year × 2 years × 90%)	<u>\$36,000</u>
(a)	\$66,000
Less: Actual Depreciation Expense charged to government contracts (\$100,000 × 50%)	(b) <u>\$50,000</u>
Additional depreciation due to extended useful life (c) = (a) - (b)	\$16,000
Less: Efficiency Reduction (\$4,000 × 90%)	(d) \$ 3,600
Increased Maintenance (\$5,000 × 90%)	(e) <u>\$ 4,500</u>
Allowable Usage Charge (c) - [(d)+(e)]	<u><u>\$ 7,900</u></u>

7-404.4 Depreciation on Intracompany Transfers of Assets

On property acquired from a division, subsidiary, or affiliate of the contractor, the auditor's attention is directed to FAR 31.205-11(k) which provides that the depreciation on any such item which meets the criteria for allowance at a "price" under FAR 31.205-26(e) may be based on such price (rather than cost to the contractor), provided the same depreciation policies and procedures are used for costing purposes for all business of the using division, subsidiary, or organization under common control.

7-404.5 Depreciation on Idle Facilities or Idle Capacity

The auditor should ascertain whether any of the depreciation costs charged to government contracts are generated by idle facilities or idle capacity as these terms are defined in FAR 31.205-17. If this is determined to be the case, the applicable depreciation cost should be treated as part of the total idle facility or idle capacity cost.

7-404.6 Depreciation Under Novation Agreements

For contracts being performed under novation agreements, depreciation allowed to the successor contractor should not exceed the amount which would have been allowed to the predecessor contractor to which the contract was originally awarded (see 7-1700).

7-405 Estimated Useful Life for Depreciation**7-405.1 The Economic Usefulness Criterion of FAR 31.205-11(e)**

Where depreciation reflected on the contractor's books/statements differs from that used and acceptable for income tax purposes, the estimated useful life of an asset should represent the prospective period of economic usefulness to the contractor as defined in FAR 31.205-11(a). When either useful life, residual value, or depreciation methods differ for book and tax purposes, then the provisions of FAR 31.205-11(e) should be applied in determining allowable depreciation costs (7-402.2(b)). Under this FAR

provision allowable depreciation shall not exceed the amounts used for book and statement purposes. If the auditor concludes, with technical assistance, if necessary, that depreciable lives used by the contractor for book purposes do not represent "economic usefulness", depreciation costs should be questioned.

7-405.2 Useful Lives Under FAR 31.205-11(d)—ADR Guidelines

Where allowable depreciation costs are to be determined under FAR 31.205-11(d) (see 7-402.2(a)), useful lives should be assigned as provided in asset depreciation range (ADR) guidelines, where applicable. These guidelines are summarized and discussed below.

a. Bulletin F-Before 1962

Before 1962, business firms depreciated property in terms of useful lives established for several thousand different classifications of assets by Treasury Department Bulletin F. Taxpayers may still use Bulletin F as a guide if they wish, but generally do not do so since subsequent regulations provide for shorter lives.

b. Revenue Procedure 62-21 - July 1962

In July 1962, Revenue Procedure 62-21 introduced a fundamental change in the concept of depreciation. As a substitute for the classifications of Bulletin F, assets were grouped by approximately 75 general asset and industrial classifications, with a "guideline life" prescribed for each of these classes. The guideline lives were approximately 30 percent to 40 percent shorter than Bulletin F lives. Revenue Procedure 62-21 also contained a "reserve ratio test," which was designed to assure that taxpayers would not continually depreciate their assets over a substantially shorter period than their actual use and replacement.

c. Introduction of ADR - June 1971

Next, the Revenue Act of 1971 authorized the "class life asset depreciation range (ADR) system." The major provisions of this system were initially approved by the Treasury Department in June 1971, and later amplified and incorporated into the 1971 Revenue Act. At the taxpayer's election, it may apply the class life ADR system for assigning asset lives to income-producing real or tangible

personal property placed in service after 1970. The asset guideline classes, asset guideline periods, and asset depreciation ranges established under the class life ADR system are stated in Revenue Procedure 72-10.

d. Revised ADR Guidelines - 21 March 1977

For assets acquired after 21 March 1977 and prior to 1 January 1981, Revenue Procedure 83-35 contains the revised ADR guidelines. The specified upper and lower limits of the asset depreciation range are generally 20 percent below and 20 percent above the guideline period established for each class of personal property. The taxpayer may select as the asset depreciation period any period of years, that is a whole number of years, or a whole number of years plus a half year, within these upper and lower limits. Realty, however, does not have asset depreciation ranges. Accordingly for land improvements, buildings, and other real estate, the asset guideline period is also the asset depreciation period.

e. Taxpayer Election of ADR System

The system is optional with the taxpayer, who has an annual election. Each year's election applies only to assets acquired during that year. A taxpayer who elects to use the class life system for a particular year must indicate such election and the class lives used in its tax return for that year. Such election is binding on both the taxpayer and the IRS and may not be modified or revoked by either party. The taxpayer must apply the system to all eligible property acquired during the year, which falls within a class for which a class life has been established, and may not arbitrarily exclude particular items. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election.

f. Asset Exclusions from ADR System

The regulations provide for exclusion of certain types of property from the ADR system. The principal exclusions permissible are for assets that are (1) subject to special rapid amortization or depreciation provisions, (2) received from related parties in a transfer that does not trigger an investment credit recapture, (3) without an ADR class, or

7-405.2f.

(4) excludable property under the 10 percent used property rule (see 7-407.6).

7-405.3 Elimination of Reserve Ratio Test — 1970

The reserve ratio test requirements are eliminated for assets placed in service after 1970, regardless of the system used for estimating useful lives. Thus, taxpayers may now compute depreciation under either the new class life ADR system or under the general rules using estimated lives, without the need for meeting the reserve ratio test.

7-405.4 The Economic Recovery Tax Act of 1981 — ACRS

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 in tax years ending after 1980. All property other than ACRS property remains under the previous system of depreciation. Under ACRS, the costs of most tangible, depreciable property are recovered over predetermined periods generally unrelated to and shorter than useful lives. The recovery deduction for each year is determined by applying a percentage specified in the law to the unadjusted basis of the property. Following are some points meant to clarify the relationship between ACRS and depreciation computed under FAR 31.205-11.

a. Use of ACRS for Financial Accounting Purposes

FAR 31.205-11(d) and (e) provide that use of a method of depreciation for financial accounting purposes is a test of an acceptable depreciation method for contract costing. In many cases, the ACRS recovery period will not be within a reasonable range of the asset's useful life and contractors will be unable to use ACRS for either financial accounting or contract costing purposes.

b. Acceptability of ACRS for Contract Costing

(1) For contractors not subject to CAS 409 but to FAR 31.205-11, under FAR 31.205-11(d), ACRS is acceptable for contract costing if (1) ACRS is also used for non-government work in the same cost center, (2) ACRS is used for finan-

cial accounting, and (3) ACRS is used for income tax purposes.

(2) Under FAR 31.205-11(e), if contractors subject to FAR 31.205-11 do not use ACRS for both financial accounting and tax purposes, ACRS can only be used for contract costing if (1) the ACRS recovery period is the same as the useful life and (2) ACRS is used for non-government work. In any case, allowable depreciation cannot exceed amounts used for financial accounting.

7-406 Depreciation Methods Under the General Rules

The methods for computing depreciation described in this subparagraph apply only when the class life ADR system has not been elected. When the ADR system is used, the rules are subject to certain modifications as covered in 7-407.

7-406.1 General Principles for Depreciation Methods**a. Acceptable Methods Under FAR**

In general, any rational and systematic method that is consistently applied may be used in computing depreciation. Regardless of the method used, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage, during the remaining life of the property.

b. Acceptable Methods Under Internal Revenue Code

Under Section 167 of the 1986 Internal Revenue Code, the depreciation allowance on new tangible property having a useful life of three years or more is presumed to be reasonable if it is computed by use of the straight-line method, the declining-balance method, the sum of the years digits method, or other consistently applied method, subject to the limitations below.

7-406.2 Straight-Line Method

Under this method the cost or other basis of the property less its salvage value is generally deducted in equal annual amounts over the period of its estimated useful life. The straight-line method can be used for any depreciable property, new or used. Only the straight-line method

can be used if the depreciation period is less than three years.

7-406.3 Declining-Balance Method

a. With the enactment of the 1954 Internal Revenue Code, taxpayers were permitted to use accelerated methods of depreciation, including the declining-balance method, at a maximum of double the appropriate straight-line rate. Subsequent amendments to the Internal Revenue Code reduced the maximum permis-

sible rate on real estate to the straight-line rate. To be able to apply the 200 percent declining-balance method (or the sum of the years digits method), the asset being depreciated must now be new, tangible personal property with a useful life of three years or more. The following table summarizes the maximum depreciation rates permitted a taxpayer for personal and real property available at the various dates.

<u>Type of Property</u>	<u>Maximum Depreciation Allowance</u>
All property acquired before 1/1/54	150%
Property acquired on or after 1/1/54:	
Tangible personal property:	
New.....	200%
Used.....	150%
Real Property:	
New — 1/1/54 to 7/24/69.....	200%*
7/25/69 to 12/31/86	150%
1/1/87 to date	straight-line
Used — 1/1/54 to 7/24/69.....	150%
7/25/69 to date	straight-line
*During a brief "suspension period" from 10/10/66 to 3/9/67 the maximum permissible rate was reduced to 150 percent.	

b. Special Considerations — Salvage Value Under Declining-Balance Method

While salvage value is not deducted from the cost or other basis of the property in determining the annual depreciation allowance, an asset may not be reduced below its reasonable salvage value. (See 7-408.2c. for the 10 percent rule regarding personal property.) Where the salvage value is large, use of the double declining-balance method may require special consideration on the part of the auditor (see 7-408).

7-406.4 Sum of the Years — Digits Method

The sum of the years digits method may be used only on property that meets the requirements for "twice the straight-line rate" under the declining-balance method described in 7-406.3a. above.

7-406.5 Other Depreciation Methods

Any consistent method of computing depreciation may be used provided that during the first two-thirds of the useful life of the property, the depreciation deductions under any such method do not result in accumulated allowances at the end of any tax year that are greater than the total that could have been deducted under the declining-balance method. Under appropriate circumstances, "other consistent methods" include the sinking-fund method, the unit-of-production method, and the machine-hour method. The limitations on the use of the declining-balance and sum of the years digits methods apply to any consistent method used other than the straight-line method.

7-407 Depreciation Methods Under the Class Life ADR System

7-407.1 Special Considerations for Contract Costing Under the Class Life ADR System

a. Asset lives and methods of depreciation established by the contractor in consonance with the class life ADR system are considered to be compatible with FAR 31.205-11(d)(3). This cost principle provides that depreciation costs are reasonable where a contractor uses the same policies and procedures for income tax reporting, contract costing, and financial reporting purposes.

b. However, due to unusual circumstances affecting defense contracts, use of the class life ADR system may result in inequitable charges to the government. If any inequities are found, Headquarters should be advised.

7-407.2 Limits on Depreciation Methods and Rates

The taxpayer may use only the straight-line, declining-balance, or sum of the years digits methods. To eliminate potential areas of dispute between taxpayers and the Internal Revenue Service, no other method is permitted under the class life ADR system. The various rates allowable under accelerated depreciation for new and used property are the same as set forth in the table in 7-406.3a.

7-407.3 Establishing and Using Vintage Accounts

a. Definition of Vintage Accounts

All assets for any tax year, for which the taxpayer elects to use the class life ADR system, must be accounted for in either item or multiple-asset accounts by the year placed in service. These accounts are called "vintage accounts."

b. Adjustment for Salvage Value

The annual allowance for depreciation of a vintage account is determined without adjustment for the salvage value of the property in such account. Accordingly, the straight-line and sum of the years digits computations are based upon the unadjusted basis of the vintage account without reduction for salvage value. In general, the original basis of the account

changes only if there is an extraordinary retirement.

c. Change in Depreciation Method

During the depreciation period for a vintage account the taxpayer may change from a declining-balance method of depreciation to the sum of the years digits method, and from the declining-balance method or the sum of the years digits method to the straight-line method without the approval of the Internal Revenue Service.

7-407.4 Asset Retirements Under the ADR System

a. Retirements in General

An asset is treated as retired when it is permanently withdrawn from use in the business. Class life ADR retirements are separated into two categories: extraordinary retirements and ordinary retirements.

b. Extraordinary Retirements

Extraordinary retirements occur when assets are destroyed by fire, storm, or other casualty, or when assets amounting to more than 20 percent of the unadjusted cost or other basis of the entire account are disposed of because business activities are terminated, curtailed, or disposed of. On an extraordinary retirement, gain or loss is recognized in the year of retirement.

c. Ordinary Retirements

With respect to ordinary retirements (all others), gain or loss is generally not recognized at the time of retirement. The sales proceeds, if any, are added to the depreciation reserve of the vintage account from which the asset is retired, and the depreciation deduction is continued as if all the assets survived for as long as the life assigned to the remaining assets in the group.

7-407.5 Conventions for First-Year Depreciation of Vintage Accounts

a. General

The allowance for first-year depreciation of a vintage account is determined by applying the "modified half-year convention" or the "half-year convention." The same convention must be adopted for all vintage accounts of a tax year, but not necessarily for those of another tax year.

b. Modified Half-Year Convention

The first-year depreciation allowance for a vintage account for which the taxpayer adopts the "modified half-year convention" is determined by treating (1) all vintage account property placed in service during the first half of the tax year as placed in service on the first day of the tax year, and (2) all vintage account property placed in service during the second half of the tax year as placed in service on the first day of the succeeding tax year. Similarly, all extraordinary retirements from the account during the first half of the tax year are considered to have occurred on the first day of the tax year and all extraordinary retirements from the account during the second half of the tax year are considered to have occurred on the first day of the succeeding tax year.

c. Half-Year Convention

The first year depreciation allowance for a vintage account for which the taxpayer adopts the "half-year convention" is determined by treating all property in the account as placed in service on the first day of the second half of the tax year. All extraordinary retirements from the account are considered to have occurred on the same day.

7-407.6 Special Considerations for Acquisition of Used Assets

The class life ADR system applies to used assets as well as new assets. However, the present ranges are geared to new property. In order to remove possible inequities, the taxpayer may exclude used property from the system if the used property placed in service during any year amounts to more than 10 percent of the total. The 10 percent test must be applied separately to Section 1245 and Section 1250 property. If the 10 percent test is met and the taxpayer elects to use this exclusion, all the used property must be excluded from the system.

7-407.7 Transitional Rules for Lives of Buildings (1971-1974)

For real property there is also a transitional rule. Revenue Procedure 72-10 does not now provide a range of lives for Section 1250 assets. Instead it furnishes a single life for each class of building. In

the meantime, the taxpayer is permitted to exclude Section 1250 property from the system on an asset-by-asset basis, provided that the particular circumstances show that a life shorter than the initially prescribed life is justified. This exclusion applies to real property placed in service on or after 1 January 1971, until such time as ranges for buildings are issued or 1 January 1974, whichever is earlier. Since no ranges were issued for buildings, the exclusion expired at the end of calendar year 1973. However, PL 93-625, which addresses Section 1250 property, permits election of ADR. To determine class life of Section 1250 property, a taxpayer may use the depreciation guidelines in effect on 31 December 1970 or on the facts and circumstances of the specific asset.

7-408 Salvage Value**7-408.1 Use and Bases of Salvage Value****a. General**

Salvage value is the amount the taxpayer expects to receive in cash or trade-in allowance upon disposing of the asset at the end of its useful life to the taxpayer. There is no fixed basis for determining salvage value. If an asset is customarily used for its full inherent life, salvage value may be no more than junk value.

b. Special Considerations in the Use of Accelerated Methods

(1) If it is the policy to retire assets that are still in good operating condition, the remaining salvage value at that date may represent a significant portion of the original cost basis, and therefore special consideration will have to be given when accelerated methods are used.

(2) While a contractor may use any acceptable method provided salvage values and estimated useful lives are realistic, the depreciation should not result in charging all allowable depreciation costs to the early years of use if an asset has a useful life to the contractor beyond that point. Where, for example, an asset costing \$100,000 has a useful life to the contractor of four years and a remaining salvage value at the end of this period of \$50,000, it is evident that use of the double declining-balance method (i.e., a

7-408.1b.

rate of 50 percent), would result in writing off all the depreciation in the first year.

(3) Costing distortions of this type run counter to the basic concept of charging depreciation costs over the estimated useful life of the asset in a systematic and logical manner. They can generally be avoided by the use of a depreciation method which recognizes salvage value.

7-408.2 Salvage Value Under the General Rules**a. Under Straight-Line and Sum of Years-Digits Methods**

The contractor may use either gross salvage or net salvage in determining depreciation, and the treatment of the costs of removal must be consistent with the practice adopted. Under the straight-line and sum of the years digits methods, salvage value is subtracted from the cost or other basis before applying the annual depreciation rate.

b. Under Declining-Balance Method

Salvage value is not deducted in computing depreciation under the declining-balance method. However, see caveats specified in 7-408.1 above.

c. Ten Percent Rule on Salvage Value of Personal Property

For taxable years beginning after 31 December 1961, and ending after 16 October 1962, a taxpayer may reduce the salvage value by any amount up to 10 percent of the cost or other basis of personal property having a useful life of three years or more. This rule applies whether the property acquired is new or used. Thus, if the property has an estimated salvage value of 10 percent or less of the basis, salvage value need not be taken into account for the purpose of computing depreciation. In no event may an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction permitted under the foregoing 10 percent rule.

7-408.3 Salvage Value Under Class Life ADR

Salvage value is not used to reduce the basis for computing depreciation (7-407.3b). However, allowable depreciation for any vintage account may not exceed the cost or other basis of the

account less the sum of (1) the reserve for depreciation, and (2) the salvage value. Thus, salvage value functions only as an overall limitation on the total depreciation allowable for property in a vintage account; however, see caveats specified in 7-408.1 above. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election. Gross salvage value must be estimated for each vintage account at the time of electing to use the class life ADR and may be reduced under the percent rule. If the taxpayer consistently follows a practice of understating salvage values, IRS will increase the salvage value to what it finds is a reasonable amount.

7-409 Additional First-Year Depreciation**7-409.1 General Provision**

Section 179 of the Internal Revenue Code provides that under certain conditions, taxpayers may elect to write off the cost of qualifying property (subject to a dollar limitation discussed below) as additional first-year depreciation. This "bonus" depreciation is computed on cost without reduction for salvage value. The deduction may be taken only in the first tax year for which a depreciation deduction is allowable on the property. Ordinary depreciation is then computed by any of the usual allowable methods on the cost or other basis of the property less the additional first-year depreciation and, where applicable, less salvage value.

7-409.2 Limitation on Cost of Property

The cost of property on which this additional allowance may be taken is limited to \$10,000 for taxable years beginning after 12/31/86. As indicated by this limitation, the principal objective of the "bonus" depreciation is to act as a stimulant to small businesses. The taxpayer may select the items, and the portions of their costs, upon which it wishes to claim the additional allowance.

7-409.3 Transactions Between Related Parties

The property must have been acquired from an unrelated person. If the taxpayer

is a corporation acquiring the property from another corporation, the transferor must not be a member of the same affiliated group. Members of such an affiliated group are not entitled to the write-off in the first year on purchases from each other. Also, the \$10,000 maximum limitation is applied to the entire affiliated group.

7-409.4 Acceptability for Contract Costing Purposes

This additional first-year depreciation is acceptable for contract costing purposes, if it meets the criteria established by IRS.

7-410 Investment Tax Credit

The investment tax credit was eliminated on 1 January 1986. The Revenue Act of 1971 had reinstated the investment tax credit as a deduction from the Federal income tax otherwise due. The credit was a direct deduction from Federal income taxes. It is DoD procurement policy not to reduce the cost basis of the assets by the investment tax credit for the purpose of computing depreciation. Further, the credit should not be used to reduce otherwise allowable costs of government contracts. In addition, since the only value of the investment tax credit is to reduce Federal income taxes, any purchase of the investment tax credit is unallowable per FAR 31.205-41(b)(1).

7-411 Consistency in Depreciation Method

7-411.1 General Rule on Consistency

Any method otherwise permissible may be applied to a particular depreciable property "account" (which may represent an individual item or a group of related items). However, once a method is adopted for any specific "account," it must be applied consistently thereafter. In general, under IRS regulations, any change in the method of computing the depreciation allowances with respect to a particular account is permitted only with the consent of the Commissioner.

7-411.2 Depreciation Method Changes Permitted Without IRS Approval

a. Change from Declining-Balance to Straight-Line Method

A taxpayer may change, without the consent of the Commissioner, from an acceptable declining-balance method of depreciation to the straight-line method. When the change is made, the unrecovered cost or other basis (less salvage value) shall be recovered through annual allowances over the estimated remaining life determined under the circumstances existing at that time. The change to the straight-line method must be adhered to unless, with the consent of the Commissioner, a change to another method is permitted.

b. Special One-time Election for Real Property

A special one-time election is allowed for real property. For the first taxable year beginning after 24 July 1969, the taxpayer may elect to change its method of depreciating Section 1250 property from any declining-balance or sum of the years digits method to the straight-line method.

c. Vintage Accounts Under the ADR System

Where the taxpayer has set up vintage accounts under the class life ADR system it may, without the consent of the Commissioner, make the changes in methods of depreciation cited in preceding 7-407.3c.

7-411.3 Consistency by Asset, Not for All Assets

Although the method used must be applied consistently to an account, it need not necessarily be used for acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate account. A taxpayer may establish as many accounts for depreciable property as desired. It is apparent from the foregoing that although the taxpayer must be consistent in depreciation methods, this consistency relates only to the application of a particular method to a particular asset account from year to year. It does not mean that the same method must be used for all assets.

7-411.4 Consistency in Accounting and Estimating

It should also be noted that the method used for each asset account in computing incurred costs should be consistent with that used by the contractor in estimating costs for pricing purposes.

7-412 Gain or Loss on Disposition of Assets

Except for ordinary retirements under the class life ADR system (7-407.4), gain or loss is invariably realized at the time a depreciable asset is disposed of. The gain or loss will represent the difference between the asset's book value and the amount realized upon its disposal. However, that will not necessarily be the amount to be considered for contract cost purposes. FAR 31.205-16 provides several bases for determining the amount of gain or loss to be recognized, as well as certain elections open to the contractor regarding cost treatment of the gain or loss. In any event, the depreciation audit program should include appropriate audit steps to assure that contract costs are determined in accordance with the requirements of FAR 31.205-16.

7-413 Depreciation of Capitalized Leased Property

7-413.1 FAR and FASB 13

This paragraph deals with leased assets which have been capitalized using the provisions of Financial Accounting Standards Board Statement No. 13 (FASB 13), Lease Costs (see 7-200). The provisions of FASB 13 were incorporated in the DAR on 1 September 1978.

a. The auditor must be aware that different cost principles could apply to the same lease, depending on the date individual contracts were signed. Contracts signed before 1 September 1978 are subject to the provisions of the lease cost principles in effect the date the contract was signed. DCAAP 7641.6, Conversion Guide for DAR, provides the text of selected cost items in DAR 15-205 for any given date subsequent to 1 July 1976.

b. FASB 13 is not mandatory until fiscal years beginning on or after 1 Janu-

ary 1981. However, if the contractor elects to follow the provisions of FAS 13 for capitalized leases, regardless of the date of the lease, the provisions of DAR 15-205.9(j), effective 1 September 1978, apply.

7-413.2 FASB 13 Summary

a. Classification of Lease as Capital Lease versus Operating Lease

From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the lease property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

(4) The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the lease property over any related investment tax credit retained by the lessor. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

b. Amortization Period

If the asset is capitalized using either of the first two criteria, the asset is amortized over the estimated economic life of the asset. If the asset is capitalized under either of the last two criteria, it is amortized over the lease term. The lease term defined in FASB 13 includes the basic term plus option periods under certain conditions. The conditions which must be part of the lease for the option period(s) to be included in the lease term are (1) lease contains bargain renewal options, (2) the lessee would have to pay a penalty so large as to assure renewal, (3) the lessee guarantees lessor's debt for the option period(s), (4) the lease contains a bargain purchase option, and (5) the lessor has the option to renew the lessee's lease.

7-414 Depreciation or Amortization of Leasehold Improvements

Improvements by the lessee are ordinarily subject to an allowance for depreciation or amortization as discussed below. The auditor should review the basis for writing off the cost of leasehold improvements.

7-414.1 Amortization versus Depreciation

Whether the lease is with a commercial concern or with the government, the cost of the improvement may be depreciated over the useful life of the improvement or amortized over the remaining term of the lease, whichever is shorter. The distinction between depreciation and amortization has some significance; the language of the regulations is generally interpreted to mean that when amortizing, the declining-balance or the sum of the years digits may not be used. When depreciating, there is no such limitation.

7-414.2 Term of the Lease

The term of the lease will include any period for which the lease may be renewed, extended, or continued pursuant to either (1) an option exercisable by the lessee or (2) in the absence of an option, reasonable interpretation of past acts of the lessee and lessor such as with respect to renewal, unless the lessee clearly establishes, past acts notwithstanding, that is improbable that the lease will be renewed, extended, or continued. Internal Revenue Code section 1.167(a)-4 and related section 1.178-1 govern the effect to be given renewal options in determining whether the useful life of the improvement exceeds the remaining term of the lease. In general, these rules establish a test for determining whether a renewal is intended, based on a comparison of the life of the improvements with the life of the lease.

7-500 Section 5 — Insurance Costs

7-501 Introduction

a. This section provides guidance for the review of contractors' insurance programs. Considerations concerning the allocability of insurance costs are covered in Cost Accounting Standard (CAS) 416 (see 8-416). Basic considerations concerning the allowability of insurance costs are covered in FAR 31.205-19. In accordance with DFARS Subpart 242.73, joint reviews of insurance costs are conducted by DLA and DCAA at contractor locations that have actual or anticipated annual sales to the government of \$10 million or more on negotiated contracts, including subcontracts (see 5-803). Due to the contingent nature of insurance charges (projected average loss) to government contracts, special emphasis should be placed on this element of cost when evaluating forward pricing proposals and forecasted indirect expense rates.

b. Contractors' insurance costs are generated by (1) insurance required to be carried by the terms of government contracts, (2) insurance maintained in connection with the general conduct of business, (3) insurance maintained because of statutory requirements, and (4) insurance maintained as part of employee benefits.

c. When developing an audit program, consideration should be given to the (1) materiality of the premium amounts involved for each type of insurance, (2) types and amounts of coverage included under self-insurance programs, (3) effectiveness of contractor's management of the insurance function, and (4) contractor's program for eliminating potential hazards which will cause loss.

d. Insurance costs are normally included in overhead expense pools for allocation to all benefiting cost objectives. Guidance for accumulating costs into overhead pools and selecting proper bases to allocate costs to final objectives is found in CAS 418 (see 8-418).

7-502 Mandatory Insurance Coverage and ACO Approvals

a. The clause in FAR 52.228-7 "Insurance Liability to Third Persons," is re-

quired to be included in all government contracts. Under the provisions of this clause, the contractor must maintain insurance coverage for third party contingencies such as (1) workers' compensation, (2) employer's liability, (3) comprehensive general liability (bodily injury), (4) comprehensive automobile liability (bodily injury and property damage), and (5) other types of third party liability insurance as required by the government. In addition, insurance coverage is mandatory under the provisions of FAR 28.301 when commingling of property, type of operation, circumstances of ownership, or conditions of the contract make it necessary for the protection of the government.

b. FAR 42.302(a)(2) requires the ACO to review contractors' insurance plans. The ACO must specifically approve, normally in advance, the form, extent, amount and period of insurance coverage in accordance with FAR 28.3. This approval, however, does not relieve the auditor of the responsibility of reviewing premium costs for allowability, reasonableness, and allocability to government contracts.

7-503 Optional Insurance and the Government's Contractor Insurance and Pension Reviews Program

a. In addition to the foregoing mandatory insurance coverage, contractors usually obtain other types of insurance such as health and welfare benefits for employees and various types of casualty insurance. FAR 52.228-7 does not require the contractor to submit these types of coverage to the contracting officer for specific approval unless requested.

b. The government's general survey and review of a contractor's insurance program, which may be performed under FAR 42.3, may be limited to verifying that the contractor's insurance program provides appropriate protection in consonance with the types of risks involved. Such a review, by itself, does not constitute a sufficient basis for accepting related premium costs. Therefore, where

insurance costs and the government's participation therein are material, the auditor should review the contractor's insurance programs to the extent required to establish whether the costs are necessary, reasonable, and allocable to government contracts.

7-504 Allowability and Allocability

a. Where such benefits are not an incidental part of a pension plan, insurance programs may be established to provide current or retired employees with fringe benefits such as health, medical services, and death benefits. The criteria for the allowability and allocability of such costs is governed primarily by FAR 31.205-6, Compensation, and CAS 415, Deferred Compensation, rather than by FAR 31.205-19 Insurance and Indemnification. Payments under these programs can constitute either current or deferred compensation. Deferred compensation is allowable only to the extent it, together with all other compensation paid to the employee, is reasonable in amount, paid pursuant to a good faith agreement between the employee and the contractor, and consistently applied in future periods. Costs which are unallowable under other paragraphs of FAR 31.2, shall not be allowable under FAR 31.205-6 or CAS 415 solely on the basis that they constitute personal compensation.

b. CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and the allocation to final cost objectives. Briefly stated, the standard requires that allocation of insurance costs to cost objectives shall be based on the beneficial or causal relationship between insurance costs and the cost objectives. It also specifies that the amount of insurance cost to be assigned to a cost accounting period is the projected average loss for that period plus insurance administration expenses incurred in the same period.

7-505 Purchased Insurance

a. Purchased insurance can usually be obtained from commercial carriers for all types of insurance. Generally, contractors

purchase insurance at fixed premiums or advance premiums which are subject to retroactive adjustments on the basis of claim experience. The auditor's review should include an appropriate examination of individual insurance policies for indications of excessive or duplicated coverage or unrealistic premium rates. During periods of high competition within the insurance industry, premium costs diminish. Therefore, the auditor should ascertain whether the contractor solicits competitive quotations periodically to determine that downward price trends are reflected in the premiums paid.

b. The government's participation in premium costs should be commensurate with the benefits received. Also, contracts should share in dividends and other credits received by the contractor, in proportion to the participation in gross premium costs. Insurance provided by captive insurers (owned by or under the control of the contractor) is considered self-insurance and must comply with the self-insurance provisions of CAS 416. Premiums paid to fronting insurance companies (companies not related to the contractor which reinsure with a captive insurer) should not exceed (excluding a reasonable service charge) the amount which the contractor would have been allowed had it contracted with a competitive insurer.

7-506 Self-Insurance

7-506.1 Contractor Elections for Self-Insurance

a. Contractors may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The contractor's decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. If purchased insurance is available, the charge for any self-insurance coverage plus insurance administrative expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administrative expenses (FAR 31.205-19).

7-506.1b.

b. Generally, the contractor will rely on self-insurance to cover ordinary risks and losses and, at the same time, maintain various forms of purchased insurance to cover major risks and catastrophic losses. For example, under a self-insured employee group health and survivorship plan the contractor usually will limit its self-insurance to providing hospital, surgical, and medical expenses and, at the same time, purchase insurance covering life, accidental death and dismemberment, disability income benefits, and dreaded disease coverage.

7-506.2 Approval for Self-Insurance

In accordance with FAR 28.308, self-insurance programs must be submitted to the contracting officer for approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated government contracts and the self-insurance costs at the segment are expected to be \$200,000 or more annually. This same section of FAR provides that programs of self-insurance covering any kind of risk may be approved when examination of such programs indicates that their application is in the best interest of the government. Self-insurance for risks of catastrophic losses, however, is not allowable in accordance with FAR 31.205-19(e).

7-506.3 Self-Insurance Administration Costs

a. A contractor may administer its self-insurance program either by employing personnel possessing the necessary technical skills, contracting with one or more insurance firms to provide the necessary services, or both. Since self-insurance costs should not exceed the cost charged by a commercial carrier, it is important that all costs be readily identifiable in the accounts.

b. In addition to losses related to claims, the cost of operating a self-insurance program should include the salaries of employees in the company's insurance department, any outside services, and all of the incidental expenses incurred such as use and occupancy, telephone, and supplies. The contractor should make periodic comparisons between the actual cost it has incurred and the cost of

premiums it would have paid to an insurance company if the coverage had been purchased.

7-506.4 Periodic Charges for Self-Insurance

a. Under a self-insurance program, the contractor shall make a charge for each period which represents the projected average loss for that period. The self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed the cost of comparable purchased insurance plus the associated insurance administration expenses. The contractor's actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner as would purchased insurance. The actual loss shall be measured by actual cash value of the property destroyed, amounts paid or accrued to repair damage, amounts paid or accrued to estates and beneficiaries, and amounts paid or accrued to compensate claimants, including subrogation. Actual losses may be used to determine self-insurance costs (1) when probable losses will not differ significantly from the projected average loss for that period and (2) under self-insurance programs for retired persons.

b. CAS 416.50(a)(3)(ii) provides that if a loss has been incurred and the amount of the liability to a claimant is fixed or reasonably certain, but actual payment of the liability will not take place for more than one year after the loss is incurred, the amount of the loss to be recognized currently shall not exceed the present value of the future payments. These future payments are to be computed using a discount rate equal to that prescribed for settling such claims by the State having jurisdiction over the claim or if no such rate is prescribed by the State, then the current Treasury Rate is to be used to discount the liability. Because many State rates are unrealistically low, using such rates to discount self-insurance liabilities will result in excessive contract costs. FAR 31.205-19(a)(3) limits the computation of the present value of future payments to an amount computed using as a discount rate the interest rate determined by the Secretary

of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect at the time the loss is recognized.

7-506.5 Broker's Quotes Used to Estimate Self-Insurance Costs

a. The use of broker quotes is an estimating technique in which contractors obtain a quote from an insurance broker and use it to represent their projected average loss. They do not actually purchase the insurance but only use the quote to determine the costs that would have been incurred if the insurance coverage had been purchased. Use of these quotes to estimate self-insurance costs for a period is generally considered an acceptable estimating technique to determine the projected average loss for the period under CAS 416.50(a)(2)(i), which states "If insurance could be purchased against the self-insurance risk, the cost of such insurance may be used as an estimate of the projected average loss; if this method is used, the self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed, the cost of comparable purchased insurance plus the associated insurance administration expenses. However, the contractor's actual loss experience shall be evaluated regularly, and self-insurance charged for subsequent periods shall reflect such experience in the same manner as would purchased insurance." Many times quotes may contain statements that actual loss experience was considered but, in reality, there is no relationship between the quoted amount and the loss experience. It is imperative that an evaluation of self-insurance costs based on broker quotes be reviewed for reasonableness, i.e., that the actual loss experiences of the contractor has been included as one of the factors in the quote used to measure the self-insurance charge, and that the quote is based on all pertinent data regarding the contractor's potential liability for the insurance coverage. Contractors should be required to adequately demonstrate that amounts claimed for self-insurance costs based on broker quotes consider these factors.

b. In addition to requiring that the quoted amounts reflect actual experience and potential liability, contractors who

use this method should be required, at a minimum, to obtain competitive quotes and to demonstrate that the use of broker quotes is also in accordance with FAR 31.205-19(a)(2)(i) in that they are based on sound business practices and the rates and premiums quoted are reasonable under the circumstances. The contractor's self-insurance program, including the use of broker quotes, should be approved by the ACO and should be in accordance with the contractor's policies and procedures and insurance manual. The contractor should maintain the difference between the estimated and actual cost in a reserve account. The account should be adjusted annually to reflect changing reserve requirements as determined by an actuary, and any adjustment should be reflected in the next year's estimated projected average loss.

7-506.6 Audit Considerations

When reviewing a contractor's self-insurance program, the auditor should evaluate (1) the types of risks covered and the nature of the contractor's risk assumption, (2) comparative costs of the program, including administrative and corollary costs, (3) effectiveness of the contractor's claims procedures, (4) equity of the accounting treatment of self-insurance costs from the standpoint of the plan of funding and allocation of costs, and (5) maintenance of the reserve in accordance with CAS 416. In reviewing the administrative and corollary costs, the auditor must assure that all appropriate costs have been taken into account and that self-insurance is economical. It should also be ascertained whether the contractor has a staff that is qualified to process claims and whether the system has internal controls that are adequate to assure accurate payment of claims to employees or third parties.

7-507 Workers' Compensation and Employer Liability Insurance

7-507.1 General

a. Workers' compensation insurance protects an employer against the liability imposed by workers' compensation laws to pay benefits and furnish medical care

¶7-507.1a.

to employees for injuries and occupational diseases attributable to their employment. Employer's liability insurance covers claims for damages relating to special types of work and injuries or occupational diseases not covered under the State laws. These types of liability coverage are not a form of personal compensation to the employee, and their allowability should be considered under FAR 31.205-19. FAR 28.307-2 requires contractors performing under government contracts to carry employer's liability coverage in the minimum amount of \$100,000, except in States with exclusive or monopolistic workers' compensation funds which do not permit the writing of such coverage by private carriers, or except in those States where the Workmen's Compensation Act constitutes the exclusive remedy of employees against employers for all injuries or diseases relating to their work. The cost of workers' compensation is affected by geographical location and the hazards of the particular work task. Therefore, the contractor's method of allocating the expense to burden centers should recognize this relationship in order to allocate the premium cost equitably.

b. Each State has its own workers' compensation laws. Accordingly, auditors should determine that contract charges for workers' compensation are in accordance with laws of the contractor's applicable state of business. Premium rate guidelines are published by the National Council on Compensation Insurance based on accident experience throughout the Nation's businesses and industries. Workers' compensation rates are based on employee occupational classifications and on covered payroll. When evaluating such rates, the auditor should determine that all applicable labor categories are used to estimate the insurance premium. The failure to include all labor categories can result in overstated premiums.

c. Usually, an estimated premium is charged when the workers' compensation policy is written. After the policy expires, a payroll audit is made. The actual premium is then determined and adjustments made. Auditors should be alert to specific policy clauses. Some policies call

for interim adjustments, such as adjustments to the estimated premium for the actual amount of labor dollars incurred on a monthly basis.

7-507.2 Retrospectively Rated Plans

a. Many workers' compensation policies are retrospectively rated. The initial premium is adjusted (up or down) at a later date, depending on incurred losses. Although there are many variations of retrospectively rated plans, an insurance company will normally go through the following steps when billing a customer under a retrospectively rated policy:

(1) The policy is written using the State bureau rates. The retrospective endorsement and provisions are attached to the policy.

(2) The premium is billed based on payrolls reported to insurance company.

(3) After the policy expires, the insurance company audits the actual payroll data. The insurance company's audited payroll amount is used to develop the standard premium used in the retrospective adjustment.

(4) Actual claims are valued by the claim department six months after the policy expires. The time lag permits accurate valuation of open cases and allows time for settlement of outstanding claims.

(5) The loss and payroll figures are then used by the insurance company to calculate the first retrospective rating adjustment.

(6) Subsequent retrospective adjustments may be made at 1-year intervals to reflect the developments on open cases.

b. The retrospective rating billing procedures should give the auditor an indication of some of the documentation available to evaluate the allowability and allocability of insurance costs.

c. Where retrospectively rated plans are used, insurance companies may hold reserves. Reserves provide for anticipated payouts after the close of the policy year. The auditor should review the written purpose of the reserve to determine that the reserve is not an unallowable deposit. The auditor should evaluate the support for the reserve and the fluctuations within the reserve. Usually, pending lawsuits, known claims, and legal repre-

sentations from attorneys are included as part of the supporting reserve package. The same documentation should be available for reserves under both a purchase plan and a self-insurance plan.

7-507.3 National Defense Projects Rating Plan

a. Ordinarily, a retrospective rating plan will result in the lowest net cost for workers' compensation insurance. However, the National Defense Projects Rating Plan described in DFARS 228.304 is intended to provide this insurance to an eligible contractor at even lower costs. The savings result partly from covering not only the employees of the prime contractor, but also those of all of its subcontractors performing work at the same location.

b. The rating plan may be applied to cost-reimbursement type contracts and, in appropriate cases, to fixed-price contracts with price redetermination provisions. A defense project is eligible for application of the plan when (1) eligible government contracts represent, at inception of the plan, at least 90 percent of the payroll for total operations at the specific locations of the project; and (2) the annual premium for insurance is estimated to be at least \$10,000. The plan is available in all States except Arizona, California, Nevada, North Dakota, Ohio, Oregon, Washington, West Virginia, and Wyoming.

c. Notify the contracting officer of any instance where an eligible contractor's workers' compensation insurance has not been placed under this plan.

7-507.4 War Hazard Insurance — War Hazard Compensation Act

a. The Defense Base Act extends workers' compensation coverage to various classes of employees engaged in work outside the United States. Where the Defense Base Act applies, the benefits of the Longshoremen's and Harbor Worker's Compensation Act are extended through the operation of the War Hazard Compensation Act, as amended (42 U.S.C. 1701 et seq.), to afford protection to employees against the hazards of war (injury, death, capture, detention). In general, war hazard benefits are payable

when the claim cannot be presented under the workers' compensation coverage because the event which caused the claim was attributable to an act of war. Benefits of the War Hazard Compensation Act are provided to all eligible employees at no cost to the employer by the Bureau of Employee's Compensation, Department of Labor.

b. Upon recommendation of the officials concerned, as prescribed in DFARS 228.305(d), the Secretary of Labor may waive the applicability of the Defense Base Act with respect to any contract, subcontract, or classification of employees. Waivers of the Defense Base Act should be considered where foreign employees are subject to compensation laws or comparable provisions of their country. In these instances, the benefits provided by the country of the employed foreign national are less than the benefits offered under the Defense Base Act and consequently the ultimate cost to the government would be less. In addition to the benefits provided under the War Hazards Compensation Act, a contractor may be required to provide supplemental war hazard insurance in order to induce employees into hazardous areas. This supplemental coverage is generally limited to U.S. citizens and professional-type foreign nationals.

7-507.5 War Hazard Insurance — FD-712 Program

The FD-712 War Hazard policy is a unique program for supplemental benefits offered by a commercial insurance company. The insurance is written directly with contractors, subcontractors, and grantees of the military departments, Department of State, Agency for International Development, or any other department, agency, or subdivision of the Federal government which is eligible to participate in this insurance (and is accepted in writing by the insurance company for this coverage). The FD-712 program provides benefits up to \$50,000 at stipulated rates as indemnity for loss of life, limb, sight, or permanent total disability. Under the Retrospective Premium Agreement, the total premiums paid are adjusted to reflect actual losses, accumulation of a stabilization fund for the payment of

future losses, accumulated interest, and incurring States' premium taxes. Any premium in excess of that calculated in the premium adjustment is payable to the Treasurer of the United States. Upon termination of the policy and after all outstanding losses have been settled, the final premium is determined and any determined excess premium will be paid to the Treasurer of the United States.

7-508 Liability Insurance

7-508.1 General Comprehensive Liability Insurance

FAR 28.307-2(b) requires general comprehensive insurance with minimum limits of \$500,000 per accident. Third party property damage liability insurance ordinarily is not required under government contracts. However, where a commingling of operations permits property damage coverage to be obtained at a nominal cost to the government under insurance carried by the contractor in connection with the general conduct of its business, the participation in such insurance cost may be deemed in the best interest of the government.

7-508.2 Automobile Liability Insurance

For automobile liability, FAR 28.307-2(c) requires coverage with minimum limits of \$200,000 per person and \$500,000 per accident for bodily injury and \$20,000 per accident for property damage. This coverage is required in a comprehensive policy covering the operation of all vehicles used in performance of government contracts.

7-508.3 Aircraft Liability Insurance

When aircraft are used in performance of government contracts, FAR 28.307-2(d) requires public liability coverage with minimum limits of \$200,000 per person and \$500,000 per accident for bodily injury and a minimum limit of \$200,000 per accident for property damage. Also, passenger liability bodily injury limits of \$200,000 per passenger is required, with an aggregate minimum limit equal to total number of seats or total number of passengers, whichever is greater.

7-508.4 PL 97-12 Prohibition of Certain Insurance Costs

Public Law 97-12 prohibits payments for commercial insurance to protect against the contractor's own defects in materials or workmanship incident to the normal course of construction. The type of insurance covered by this public law should not be confused with professional liability insurance, such as that maintained by architects and engineers covering liabilities to third parties arising from errors, omissions or negligent acts. The public law is not intended to cover liability insurance for damages (third party suits) arising as a result of the use of the product. Rather it is intended to make unallowable costs to repair defects in materials or workmanship. Accordingly, the public law cannot be cited as a basis for questioning costs of third party liability insurance. However, this does not mean that professional liability insurance may not be questionable due to lack of allocability to government contracts in accordance with 7-508.5, Professional Liability Insurance.

7-508.5 Professional Liability Insurance

a. Professional liability insurance (also referred to as architects and engineers or errors and omissions insurance) protects against damages to clients or third parties resulting from professional errors or judgments. The cost of professional liability insurance is allowable, subject to tests of reasonableness and/or allocability. In performing these tests, if the cost of insurance is material, the auditor should review the policy coverage and claims and loss experience.

b. Reviewing policy coverage is the first and most important step in determining allocability and reasonableness. If a contractor's liability insurance policy provides coverage for its general practice, allocation of premiums to all contracts through overhead or general and administrative expense is usually acceptable. However, if this policy is written to provide unique liability coverage for a particular business segment or product, costs should be directly allocated to the benefiting cost objective. Where a plain reading of the policy does not clearly

establish the general nature of the coverage or the auditor has reason to believe that unique liability coverage is involved, an examination should be made of the types of services being rendered to both the government and commercial customers. If the services (service primarily refers to discipline, such as architectural, mechanical, civil engineering work, etc.) are essentially similar, a broad-based allocation is acceptable. On the other hand, where the services are dissimilar, examination should be made of the claims and loss experience as explained below.

c. If the costs are material, and the contractor does not provide the same service to the government as to the commercial customers, then the auditor should review claims and loss experience. (Claims are always defined in the policy.) This could give the auditor some added insight into the applicability of policy coverage as well as allocability of costs. Items reviewed should include a number of settled and pending claims, whether they apply to government or commercial contracts, and the dollar amounts. The auditor must exercise judgment in selecting a time frame to review claims history relevant to the costs under review.

(1) The existence of claims on either government or commercial contracts alone is not conclusive as to how premiums should be allocated. However, a significant number of claims arising because of one particular product, segment, customer, etc., may indicate the need for a more thorough review of the nature of the service or projects causing the claims disparity and consideration of a more appropriate allocation base.

(2) The review of claims and loss experience should only be used to challenge the broad-based allocation of costs where the auditor can determine that the insurance is primarily purchased to protect against liability unique to particular types of services, components, or projects.

d. In determining premiums for a contractor, the insurance carrier usually considers such factors as location of the business, size of the firm (billing/revenue), professional discipline(s) being practiced, and loss experience. The prop-

er allocation of premium costs should be determined primarily by the terms of the coverage where services provided are essentially the same for all final cost objectives. While claims and loss experience may vary considerably from year to year, and between classes of businesses (i.e., government vs. commercial), such experience should not be used to challenge the broad based allocation of premium cost unless it can be determined that the services provided are essentially dissimilar and hence the risk of claims is proportionally greater for certain services than others.

7-508.6 Product Liability

a. In the normal course of doing business, a contractor will insure itself against bodily injury to others, and damage to, or loss of, property of others arising from the failure of its products. A common basis for this premium is sales. The cost applicable to military versus commercial products should be easily determinable unless an average composite liability rate is used for both.

b. Such a composite rate may be inequitable, and should be discussed with government contract management personnel and the contractor for the purposes of obtaining separate rates for military and commercial products. For the most part, major defense contractors have negotiated separate rates, but the rates for military products still may be excessive in relation to the actual losses resulting from failure of military products.

c. Auditors should ascertain that the contractor has conscientiously attempted to negotiate with its insurance carrier a separate military products rate commensurate with the loss experience of such products. Whenever premium rates are not commensurate with loss experience, obtain the views of the government contract management official relative to rating the coverage. Further, ensure there is no absorption by government contracts of premiums solely applicable to a contractor's commercial products.

d. Audit evaluations of product liability insurance premium allocations should, as a minimum, include an analysis of the government and commercial loss experi-

ence for a representative period. Government premium breakout allocations in excess of the average government loss experience may be unreasonable. If an excess exists, additional audit considerations would include (1) comparisons of premiums and allocation bases with comparable companies; (2) requesting detailed explanations from the insurance carriers on the basis of the premium split between commercial and government and a breakdown of risk exposure; and (3) if possible, obtaining independent quotes from other insurance carriers on government exposure only. Where aircraft product liability insurance is allocated on a sales base to government contracts, auditors should specifically review for compliance with CAS 403.40(b)(4) and 403.60(b) if a home office, and CAS 410.50(g)(2) if an operating segment. Where a breakout between commercial and government is not provided, exceptions to proposed costs should be considered as noncompliances with the standards as well as FAR 31.201-4(b). Advance agreements between the government and contractors on acceptable government premium costs should clearly state the basis of the agreement and how future costs will be allocated.

7-508.7 Insurance for Government-Owned Property

FAR 31.205-19(a)(2)(iv) states "Costs of insurance for the risk of loss of or damage to Government property are allowable only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage that results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers or other equivalent representatives." Accordingly, where the risk of loss is not

the responsibility of the contractor, the cost of insurance coverage should be questioned.

7-509 Casualty Insurance

7-509.1 Fire and Comprehensive Casualty Insurance

Fire insurance provides for reimbursement to the insured for losses resulting from the causes enumerated within each policy. Most of these policies will include hazards in addition to fire, such as hail, windstorm and earthquake. When such is the case, the policy is usually referred to as a multiple peril or comprehensive policy. These policies ordinarily cover buildings, capital equipment, inventories, and supplies belonging to the insured. With respect to buildings, rating bureaus established under the various State insurance departments are responsible for setting the rates for each type of building. Self-insurance is most appropriate where a contractor's plants are isolated and scattered over a wide area, thereby dispersing the risk.

7-509.2 Fidelity Bonds

Fidelity bonds provide protection against defalcation and theft by employees, especially those in positions of trust. The auditor should become familiar with the circumstances involved in any claim for loss, inasmuch as it indicates a failure of internal control.

7-509.3 Insurance on Lives of Officers and Owners

Costs of insurance on lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation. The auditor should review the insurance policy to determine who is the beneficiary on the policy.

7-600 Section 6 — Pension Costs**7-601 Introduction**

This section provides guidance for the review of pension plans. Basic considerations concerning the allocability of costs of retirement and pension plans are found in Cost Accounting Standards (CAS) 412 and 413 (see 8-412 and 8-413). Basic considerations concerning the allowability of costs of retirement and pension plans are in FAR 31.205-6. In accordance with DFARS Subpart 242.73, joint reviews of pension costs are conducted by DLA and DCAA at contractor locations that have actual or anticipated annual sales of \$10 million or more on negotiated contracts, including subcontracts (see 5-803). See 9-703.8 for guidance on evaluation of pension costs in contractor indirect cost estimates.

7-602 Definitions and Terms

Due to the complexity of this audit area and the unique terms used in the laws and regulations regarding pension plans, auditors should have a working knowledge of the terms and definitions found in CAS 412 and 413. The auditor should always exercise due care in selecting terms to describe specific issues when reporting the results of audit of pension plans.

7-603 Approval and Review Requirements

a. Most pension plans are submitted to the Internal Revenue Service (IRS) for approval. Generally, the IRS will issue a "favorable determination letter" if the plan meets required qualifications. A plan that satisfies the requirements of section 401(a) of the Internal Revenue Code (IRC) is considered to be a qualified plan. If a plan is qualified, the sponsor is entitled to claim contributions to the plan as tax deductions, while the plan participants are not required to claim earned benefits until they are received. If a contractor's plan is qualified, a copy of the "favorable determination letter" should be in the permanent files. Some of the more important plan qualifi-

cation requirements are (1) the employer's contributions to the plan must be irrevocably funded, (2) the plan must be intended to be a permanent plan and must be in writing and communicated to the employees and (3) the plan must not discriminate either in contributions or benefits in favor of officers, supervisors or highly compensated employees. Approval of a pension plan by the IRS does not of itself necessarily require audit acceptance of the cost of the plan.

b. The auditor should notify his or her regional office in writing when a contractor has a pension plan in effect that will require assistance of the regional office in evaluating the pension plan costs. In the event of a transfer of audit cognizance to another FAO, the relinquishing FAO should prepare a detailed summary of the current pension issues for the FAO that has assumed responsibility for the pension reviews. The summary should include data on the change in accumulated assets and liabilities in employee benefit funds as a result of any mergers, acquisitions, and divestitures. See 1-502 for additional comments on transfer of audit cognizance.

c. When assistance or guidance is needed by the regional office on a plan or any of its features, the matter should be referred to the Assistant Director, Policy and Plans.

7-604 Types of Pension Plans

a. There are various types of pension plans. Each type will have a formal written document describing details of the plan. Employers will also usually have explanation and announcement booklets, prepared for employees, that provide additional information about each plan.

b. Plans can be classified as insured or trustee, defined benefit or defined contribution, contributory or noncontributory. Some plans will be a combination of these classifications.

c. A plan is called an insured type if its funding agency is an insurance company. Here, the plan sponsor makes contributions to an insurance company, and the insurance company issues various types

of contracts to provide the designated plan benefits. Some insurance arrangements provide investment services only, without guarantees of benefits, investments or earnings.

d. A plan is called a trustee type if its funding agency is a trust fund. Contributions go to the trustees who in turn invest and manage the assets and pay the stated benefits. The trustees can be third parties, such as banks, or individuals, including employees of the contractor.

e. A plan is called contributory if the participants are allowed (or required) to make contributions to it, usually in the form of payroll deductions. A non-contributory plan does not permit contributions by plan participants.

7-605 Considerations in Evaluating Acceptability of Claimed Pension Plan Costs

7-605.1 Reasonableness of Costs of Plan and Overall Compensation of Participating Employees

a. A comparison of the ratios of current and past service costs of a given contractor's plan to the total basic payroll of participants (or to the total basic payroll of all employees), with similarly calculated ratios of similar industries in the area, will furnish a yardstick for the measurement of the overall reasonableness of the costs of the plan. While these results may not be conclusive, they may be indicative of plans which warrant a more thorough analysis of the factors affecting costs.

b. Pension Fund Valuation and Rate of Return.

(1) There are two methods used to accumulate pension plan assets. One method is to purchase insurance contracts. A second method is to make contributions to a trust fund. CAS 413.40(b) requires the valuation of all pension fund assets using a valuation method which takes into account unrealized appreciation and depreciation of the assets. A realistic value must be placed on the fund for proper determination of funding requirements. The current value or a method that takes into account current value should be used. When plan asset values rise, funding contribution requirements will usually fall. The con-

tractor should compute this impact on the pension expense. In many cases, contractors will make this assessment prior to the issuance of the actuarial report on the plan. In rising financial markets, the auditor needs to insure that the government receives the full benefit of the reduced costs in the pricing and costing of all contracts (cost type and fixed-price type). Consequently, contractor price proposals, indirect cost rate forecasts, and forward pricing rate agreements need to be reviewed and evaluated to determine if they contain the reduced forecasts due to lower pension expense.

(2) The interest rate assumption is an extremely important factor in computing current contribution requirements and should be compared with the actual or approximate rate of return on the securities in the fund. If it is not reasonably close, then appropriate evaluation of this factor should be performed by the auditor.

(3) It is not intended that auditors should attempt any significant recalculations of pension plan rates, as this can best be done by the actuaries. However, information on the market value of the fund and the rate of return should be available from the contractor.

7-605.2 Other Considerations in Evaluating Acceptability of Claimed Costs

a. Allocation and Assignment of Costs

(1) Pension costs accorded audit approval under DoD contracts should bear a reasonable relationship to the pension costs generated by eligible employees engaged in work under DoD contracts. The allocation basis of pension plan costs should recognize differences of employment status, within practical limitations, between employees engaged in DoD production and employees engaged in other than DoD production. Further discussion of the allocation of costs is included in the paragraphs on past service costs and reversionary credits.

(2) Pension costs should be assigned to cost accounting periods in accordance with sound accrual accounting practices. Pension costs are often computed for a plan year that does not coincide with the contractor's cost accounting period. A

potential problem arises if the contractor assigns such costs to a single cost accounting period, rather than prorating the costs between the two contemporaneous periods. This practice would be in noncompliance with CAS 406.50(b), which requires accrual practices to be "Appropriate," because it would not be in accordance with generally accepted accounting principles (see 8-406). This practice would also be in noncompliance with CAS 412.40(a)(1) and (c) (see 8-412), which requires pension costs to be computed for a cost accounting period. Contractors' accrual practices for pension cost should be reviewed, and material noncompliances should be reported to the contracting officer. See also 6-608.3b.(1).

b. Allowability of Unfunded Pension Plan Costs

Following are key dates and associated rules governing the allowability of unfunded or pay-as-you-go pension plan costs for contracts negotiated in accordance with procurement regulations:

(1) For contracts entered into prior to 22 March 1983, pay-as-you-go pension costs accrued in accordance with CAS 412 and allocated to government contracts are allowable. This is in accordance with the decision in *U.S. v. The Boeing Co.*, 802 F.2d 1390 (Fed. Cir. 1986).

(2) For contracts entered into after 21 March 1983 but before 28 March 1989, allowable pay-as-you-go pension costs accrued in accordance with CAS 412 and allocated to government contracts are limited to the amount paid in the year the costs are assigned. This limitation is in accordance with FAR 31.205-6(j)(5).

(3) For contracts entered into after 27 March 1989, allowable pay-as-you-go pension costs are limited to the amount computed in accordance with CAS 412 and 30.413. Funding is not required for allowability. This is in accordance with changes to FAR 31.205-6 effective 28 March 1989 (see FAR 31.205-6(j)(3)(i)(B)).

c. Reversion Credits Arising From Cancellation of Non-vested Benefits (see also 6-608.2d.(5)).

(1) When an employee withdraws from a pension plan or terminates his or her employment for reasons other than re-

tirement or death, employer contributions made on his or her behalf, plus interest, to which no vested rights attach, serve to reduce the contractor's required future contributions. These are referred to as "reversion credits" (or in some cases "withdrawal gains"). While other credits or gains come within the scope of a reversion credit, the term as used in this paragraph relates to reversion credits arising from separation of employees who have not acquired vested rights. Reversion credits require particular attention because of the long term nature of pension plans and the possibility that completion or termination of government work will cause a serious cutback in a contractor's labor force. Since the contractor's annual contribution to a pension plan is net of that portion of any reversion credits used in determining the amount of the contribution, government contracts ordinarily would share in such credits to the extent that the net contribution for the year is included in the indirect cost pools and allocated to government contracts.

(2) Where the plan is funded through a contract with an insurance company, there is normally no advance consideration given to reversion credits. The necessary adjustment is normally applied as a reduction of the contractor's contribution to the insurance company for the then current taxable year or the next succeeding taxable year (or years in order of time if the aggregate amount of credit exceeds the premium cost otherwise due for the next succeeding taxable year). Reversion credits are usually quite readily ascertained under the insured type of funding arrangement.

(3) Where the plan is of the self-insured trustee type, the annual reversion credits normally reduce the employer's unfunded liability, and are therefore spread over later years (often the expected future service of members) and are only partially accounted for in any one subsequent year. Under most trustee type plans, isolated determination of the value of reversion credits is difficult to accomplish with any degree of accuracy.

(4) Ordinarily it will not be necessary to adjust for reversion credits arising from normal turnover of employees ex-

cept to consider such reversion credits in calculating the contractor's net annual contributions. However, adjustment should be made if failure to do so would result in serious inequities to either the contractor or the government.

(5) Substantial reversion credits may occur at a time when government work has decreased to a point where it will not share the credits in the proportion that it absorbed the costs of pension contributions from which they are generated.

(6) One method for protecting the government's interest in abnormal reversion credits is the use of a "recapture" method whereby the contractor and the government enter into an agreement to negotiate a refund to the government, if and when appropriate.

(7) The contracting officer has the responsibility for sponsoring the negotiation of all recapture agreements on pension costs under DoD contracts. Accordingly, where a recapture agreement is required for the protection of the government's interests in future reversion credits, a copy of the pension plan together with an advisory report containing comments and recommendations shall be submitted to the contracting officer.

d. Funding Requirements

(1) When contributions are paid by a contractor to pension, profit sharing and employee stock ownership (ESOP) plans less frequently than quarterly, FAR 52.232-16 (progress payment clause) and FAR 52.216-7/8 (allowable cost, fee, and payment clause) provide that the accrued costs shall be excluded from indirect costs for payment purposes until such costs are paid.

(2) For contracts subject to one of the payment clauses cited in (1) above, contractors are permitted either to fund pension plans in total or to fund only those pension costs allocable to contracts containing the payment clause. Partial funding and delayed funding result in loss of earnings on trust fund assets and therefore result in increased future contributions and increased contract costs. Such increased costs are unallowable per FAR 31.205-6(j)(3)(iii), which states that "Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are

assignable, are unallowable." Contractors' actuarial rates and methods used in calculating normal and past service costs should be used to compute such unallowable pension cost contributions.

(3) Loss of earnings may impact future years' pension costs, and the unallowable cost should therefore be assigned to the years affected. Unallowable pension cost assigned to future years should be compounded with interest and actuarially amortized over the appropriate future years. As an alternative, however, if mutually agreeable, the unallowable pension cost can be assigned to the current year at the present value. This latter approach may, in fact, be preferable because there would then be no need for any follow-up action related to future adjustments.

(4) Form 5500, Report of Employee Benefit Plan, is required by the IRS to be submitted annually. This form identifies the actuarial assumptions used to determine pension costs and may be used to determine whether actual funding complies with FAR requirements. If the form discloses that late funding occurred, questioned cost (lost earnings, including the compounding effect on future years) should be computed using the actuarially assumed interest rate used by the contractor in computing pension costs.

e. Actuarial Assumptions. The auditor should be alert for understated actuarial assumptions such as the interest rate assumption which results in increased pension cost. However, actuarial assumptions should be reviewed in the aggregate; although one or more of the assumptions may be unduly liberal or conservative, it is the combined effect of all assumptions that determine their validity.

7-606 Advance Agreements for Pension Plans

7-606.1 Overfunded Pension Plans

a. For government contracting purposes, a pension plan is overfunded if the value of the plan's assets is greater than the accrued liability plus normal cost for the current period, measured by the plan's actuarial cost method. This definition is the same as the definition used by the IRS prior to the signing into law on 22 December 1987 of the Omnibus Bud-

get Reconciliation Act of 1987. The new law (P.L. 100-203) made a significant change to the way a contractor measures the full funding limitation for making contributions to its defined benefit pension plans under IRC regulations.

b. A pension plan is fully funded under P.L. 100-203 when the value of plan assets equals or exceeds the lesser of (1) 150 percent of current liability or (2) the accrued liability under the plan. This method of computing the full funding limitation is effective for years beginning after 31 December 1987. Prior to the new law, a pension plan was fully funded in accordance with the Internal Revenue Code (26 U.S.C. 412(c)) when the value of plan assets equaled or exceeded the accrued liability plus normal cost for the current period under the plan.

c. Pension expense should be accrued only when there is a valid pension liability. A valid liability exists for pension costs when a plan's accrued liability plus normal cost for the current period exceeds the plan asset values when evaluated under an acceptable actuarial cost method. Accordingly, a contractor has incurred a valid liability if it has not reached the full funding limitation under the old law. This liability should be assigned to the current cost accounting period even if it exceeds the full funding limitation under the new law. However, if there is no valid liability (asset values exceed the accrued liability), there should be no pension costs assigned to the current period nor should costs be questioned in future periods for lost interest related to pension costs computed in excess of this full funding.

d. P.L. 100-203 may pose a problem for some government contractors if the pension costs computed in accordance with CAS 412 exceed the full funding limitation under this law. Under CAS 412, valid pension costs assigned to an accounting period cannot be reassigned to any other accounting period. In addition, costs assigned to an accounting period and not funded by the time set for filing a Federal tax return will not be allowable in accordance with FAR 31.205-6(j)(2)(i). To mitigate this conflict, on 8 April 1991 the new CASB authorized Federal procuring agencies to

waive the cost assignment provisions of CAS 412.40(c), on a case-by-case basis (see 8-412.2).

e. Contributions made to a fully funded plan are subject to a 10 percent excise tax in accordance with the Tax Reform Act of 1986. This 10 percent excise tax is unallowable for government contracting purposes. The allowability of taxes is governed by FAR 31.205-41. Although this section of the FAR does not specifically identify the excise tax on IRS non-deductible contributions as unallowable, it does identify in 31.205-41(b)(6) as specifically unallowable taxes on accumulated funding deficiencies of, or prohibited transactions involving, employee deferred compensation plans. It is DCAA's opinion that the excise tax imposed by the Tax Reform Act of 1986 is similar to these unallowable taxes. This opinion coupled with the language in FAR 31.204(c), that determination of allowability shall be based on the principles and standards in FAR subpart 31.2 and the treatment of similar or related selected items, makes the excise tax unallowable.

f. An evaluation of current billing and bidding indirect expense rates should be made to determine whether or not forecasted pension expenses are valid. If a contractor plans to limit contributions to its pension plan based on the full funding limitation in P.L. 100-203 and the current or forecasted indirect expense rates include an amount for pension expense based on the old full funding limitation, pension costs may be overstated. If this is the case, and there is a material impact, a recommendation should be made to the cognizant contracting officer to withdraw the rates.

g. The auditor must keep in mind that a pension plan can be overfunded on a termination basis and yet be underfunded on an accrual (ongoing) basis. A pension plan is overfunded on a termination basis when the value of the plan's assets exceed the accrued liability computed in accordance with the plan benefit formula at a specific point in time. A pension plan is overfunded on an accrual basis when the value of the plan's assets exceed the accrued liability computed

¶7-606.1g.

using assumptions projected to some future date.

h. The accrued liability can be computed by the entry age normal, unit credit, or projected unit credit funding method. The method used must be applied on a consistent basis. On a termination basis the accrued liability is computed as stipulated by the plan's provisions which govern a termination. The value of a plan's assets, for the purpose of determining a funding status, is the actuarial value computed in accordance with the requirements of CAS 413.

i. When a contractor's pension plan becomes fully funded, there is no valid liability to the pension fund and thus no cost is assignable to the accounting period. Full funding or the potential for full funding may create the opportunity for a contractor to receive windfall profits. For instance, the pension plan may not be fully funded at the time contracts are priced or negotiated. If it becomes fully funded subsequent to negotiation of a fixed-price contract, the contractor could receive windfall profits. Moreover, a contractor, after becoming aware of a full funding status, may choose to terminate its plans, pay off the participants, and keep the excess assets for corporate use.

j. The potential for windfall profits under these conditions creates a need for advance agreements to protect the interests of the government. The government pays its allocable share of pension costs over the years and should receive its share of any credits, refunds, or reduced expenses if a plan becomes fully funded or is terminated. If it is determined that a pension plan is overfunded or potentially overfunded on an accrual basis, then all pension costs both in forward pricing actions and in current contract billing rates should be questioned for the overfunded or potentially overfunded period(s) when there is no advance agreement (see 7-606.2).

k. When pension costs are being measured and assigned to cost accounting periods in accordance with CAS 412, and the plan is overfunded on a termination basis, the government is vulnerable to a contractor's management decision to terminate the plan. A decision by a contractor to terminate an overfunded pension

plan (either on a termination basis or on an accrual basis) can result in a significant windfall profit on firm-fixed-price contracts. Accordingly, forward pricing audit reports should explain the risk to the government related to forecasted pension costs and should recommend that an advance agreement be a condition of awarding a contract. When there is an indication that a plan may be terminated, and the contractor refuses to enter into a termination advance agreement (see 7-606.3), costs should be questioned in forward pricing actions and in contract billing rates.

7-606.2 Full Funding Limitation Advance Agreements

a. A full funding situation occurring subsequent to contract negotiations can result in overpricing to the government on fixed-price type contracts. Pension costs allocated to the contracts after full funding will be less than estimated and negotiated in the contract price. The full funding advance agreement serves to protect both contracting parties in the event a pension plan becomes fully funded during the course of contract performance. First, it allows the contractor to forecast pension expense even though its pension plan is fully funded or nearly fully funded. That way if the plan is not fully funded at the close of the accounting period, valid pension costs can be accepted. On the other hand, if the plan is fully funded at the close of the accounting period, the government will receive an equitable credit.

b. This credit does not necessarily have to be recovered through contract price adjustments. Adjustments to indirect rates may accomplish the same objective. Accordingly, auditors should discuss with the ACO alternative means of recovery which consider equity and administrative feasibility. However, the adjustment should result in substantially the same recovery from the same procuring activities as would be attained by contract-by-contract price adjustments.

c. The contract price adjustment for the full amount of the government's portion of the actuarial surplus shall either (1) be made in the year when the full funding limitation is reached or (2)

be used to reduce current and future costs in accordance with an advance agreement. However, the parties may decide to immediately take the full reductions to indirect costs in the year of surplus if the contract mix would yield a reduction in costs on government contracts that equates to the government's fair share of the surplus. This approach eliminates the need to keep records of the government's portion of the actuarial surplus and could effect reductions in contract prices that may be in excess of the pension costs for that year.

d. If a contractor refuses to enter into a full funding advance agreement, and its plan is fully funded or there is a potential for the plan to become fully funded on an ongoing or accrual basis, then all pension costs both in forward pricing actions and in current contract billing rates should be questioned for the fully funded or potentially fully funded period(s).

7-606.3 Plan Termination Advance Agreements

a. Effective 20 September 1989, contracting officers are required to insert a clause (FAR 52.215-27) into all solicitations and contracts for which the submission of certified cost or pricing data is anticipated. This clause requires that a contractor notify the contracting officer in writing when it determines that a defined benefit pension plan will be terminated. If a termination results in pension fund assets reverting to the contractor and the contractor has at least one contract that contains the clause, the government is entitled to an equitable share of the reversionary credit. The equitable share should reflect the government's participation in pension costs through those contracts for which certified cost or pricing data were submitted or which are subject to FAR 31.2. This means that both cost type and fixed-price contracts are considered when the amount of credit or refund is computed.

b. For contracts executed prior to 20 September 1989, the ASBCA issued a decision on *NI Industries*, ASBCA 34943, which clearly established the government's right to share in excess defined-benefit, pension-plan assets that revert to a contractor. This right is de-

rived from the credits provision of the cost principles (31.201-5). The assignment of claims required by the Allowable Cost and Payment contract clause also provides the government the right to share in the part of the reversion applicable to closed-cost type contracts. Accordingly, the auditor should cite the credit cost principle and the Allowable Cost and Payment contract clause as the basis to assert the government's right to share in reversions for contracts awarded before 20 September 1989.

c. In addition to asserting the government's right to receive an equitable share of pension reversionary credits (FAR 52.215-27, effective 20 September 1989), the FAR encourages the establishment of an advance agreement. Such an agreement can avoid future disputes on the treatment of excess fund assets resulting from defined benefit pension plan terminations. Accordingly, advance agreements between the government and the contractor should be sought by the contracting officer to clearly identify how the amount of any credit or refund will be measured.

d. When the government and the contractor have not entered into an advance agreement as described in c. above, issue a memorandum to the ACO recommending the execution of such an agreement. The following language is suggested for use in the memorandum:

The contractor maintains a defined-benefit pension plan for its employees. FAR 31.205-6(j)(4) provides that when excess or surplus assets revert to the contractor as a result of the termination of a defined-benefit pension plan, or such assets are constructively received by the contractor for any reason, the contractor shall give a refund or credit to the government for its equitable share. The government's equitable share of any reversionary credit applicable to the termination of a defined benefit pension plan should be based upon the government's participation in pension costs of all contracts requiring certified cost or pricing data. We recommend that the government and the contractor enter into an advance agreement in accordance with FAR 31.109 to avoid possible disallowance or future disputes arising from the

termination of a defined-benefit pension plan. The advance agreement should describe how the credit or refund will be measured and provided to the government.

e. When appropriate, include the same recommendation in applicable audit reports to the ACO (e.g., forward pricing rates and contractor pension and insurance reviews). For proposal audit reports, inform the PCO that an advance agreement has not been reached (see 10-307.5d).

7-606.4 Transfers of Pension Fund Assets to Other Post-retirement Benefit Funds

a. FAR 31.205-6(j)(3) was revised effective 23 September 1991 to require an advance agreement regarding the withdrawal of pension fund assets which are to be transferred to another post-retirement benefit (PRB) fund. The advance agreement is to ensure that the increased pension costs to the government in all future periods is offset by a corresponding reduction or avoidance of future PRB costs to the government, as a result of the pension fund transfers.

b. Transfers made without an advance agreement will be treated as a withdrawal of pension funds subject to FAR 31.205-6(j)(4) (see 7-606.3).

7-607 Accounting for Pension Costs in Accordance with Financial Accounting Standards Board (FASB) Statement No. 87

7-607.1 General

Starting in 1987, companies were required to implement the provisions in FASB Statement No. 87 for financial and reporting purposes. The statement was developed using (1) the concept of conservative accounting for the components of pension cost, (2) realistic statistics on companies' pension plan current obligations, and (3) the reporting of company financial pension obligations on the balance sheet. The mechanics and formula for the calculation of pension cost under the statement are different from those now permitted for contract costing purposes under CAS 412 and 413. Accordingly, just because a plan is in compliance

with Statement No. 87 does not mean that it is in compliance with CAS 412 and 413.

7-607.2 Actuarial Cost Methods

a. Statement No. 87 only permits the use of either the unit credit actuarial cost method (used for fixed-benefit plans) or the projected unit credit actuarial cost method (used for percent of final pay plans). The spread gain method is no longer permitted for either financial or government cost accounting.

b. In addition to the unit credit and the projected unit credit actuarial cost methods, CAS 412.50(b)(1) allows the contractor to use the entry age normal actuarial cost method. This additional actuarial cost method may be used because it identifies separately normal costs, any unfunded actuarial liability, and periodic determinations of actuarial gains and losses.

7-608 Accounting for Early Retirement Incentive Payments

a. Early retirement incentive payments are payments offered to employees to induce them to terminate their employment and receive immediate pension benefits. The payment is usually a lump-sum amount based on a formula which takes into consideration the employee's current salary and years of service.

b. Early retirement incentive plans which are not paid for life or offer payments for life do not represent life income settlements and therefore do not qualify as pension plans. However, FAR 31.205-6(j)(7) requires that in order to be allowable, the cost of early retirement incentive plans be accounted for and allocated in accordance with the contractor's system of accounting for pension costs. These costs should be treated the same as pay-as-you-go supplemental pension plans. FAR 30.412-50(b)(4) provides that the cost of benefits under a pay-as-you-go pension plan shall be measured in the same manner as are the costs of defined benefit plans whose benefits are provided through a funding agency.

c. Early retirement incentive payments are generally made to participants over a period of time shorter than the amortization period required by FAR. However,

for cost assignment, incentive payments must be treated as increases in pension benefits that result from unfunded past service liabilities and be amortized over the amortization period stated in FAR 30.412-50(a)(1)(iii). The amount of increased past service liability from the incentive award is the net present value of the allowable portion of the incentive at the payment date (see 7-1907.1). Under pension accounting concepts, amounts funded or costed in future periods for prior years' unfunded liabilities contain interest in an amount actuarially determined.

7-609 Costs of Post-retirement Benefits Other Than Pensions (PRB)

7-609.1 Definition and Regulation

Post-retirement benefit (PRB) costs are defined and the criteria for allowability is set forth in FAR 31.205-6(o). In general, the costs are for benefits provided for specified purposes to contractor employees after retirement. The same benefits are the subject of FASB Statement 106.

7-609.2 Allowability Determination

a. The costs must be reasonable and must be incurred according to a plan set by law, employer-employee agreement, or an established policy of the contractor.

b. The costs will be measured and assigned to accounting periods using one of three methods: Cash Basis, Terminal Funding, or Accrual Basis.

c. Cash Basis costs are recognized when actually paid to provide benefits to retirees for the current period. These costs have actually been incurred, have been paid out, and are for only the current period's benefits. The costs may include the amortization of prepaid costs over the applicable amortization period.

d. Terminal Funding occurs when the entire cost of a retiree's post-retirement benefit is accrued and funded upon the termination of the employee. This accounting method is not addressed in the cost principle but is provided by CAS 416.50(a)(1)(v)(C) for retiree insurance programs. The funding is accomplished by purchase of a paid-up benefit or by deposit of an amount equal to the present

value of the projected benefit in a trusteed fund. The CAS requires the amount terminally funded to be amortized over 15 years for government costing. If a non-CAS covered contractor proposes this accounting and funding method, it should be evaluated for allowability as a form of the Cash Basis method; i.e., amortization of prepaid costs over an appropriate period.

e. Accrual Basis recognizes costs in accordance with FASB Statement 106. Compliance with FAS 106 and FAR 31.205-6(o) should also be considered as satisfying CAS 416 provisions which require that pre-funded retiree insurance programs "apportion the cost of the insurance coverage fairly over the working lives of active employees in a plan." FAR 31.205-6(o) places the following requirements on accrued PRB costs:

(1) Costs must be funded by the time set for filing the Federal income tax for the period.

(2) Increased costs resulting from funding delays beyond 30 days after the end of each contractor fiscal quarter are unallowable.

(3) The allowable amount of past service cost is limited to the amount calculated using the FAS 106 amortization method provided for "transition liability." The past service costs of PRB plans are the previously unrecognized costs which would have been recognized during prior years if the contractor had been accruing the PRB as earned over the working lives of the employees. "Transition liability" is a term used in FAS 106 which, for contract costing purposes, is substantially the same as past service costs. (FAS 106 also allows an immediate recognition method for transition liabilities which the FAR does not allow for government costing purposes.)

f. Funding of PRB costs under either the Terminal Funding or the Accrual Basis methods must be made by payment to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRB.

g. The government is entitled to an equitable share of any PRB funds which revert or inure to the contractor.

7-700 Section 7 — Patent and Royalty Costs

7-701 Introduction

This section provides the general audit guidance in reviewing patent and royalty costs under FAR, DoD FAR Supplement, and 37 CFR Chapter IV, Part 401.

7-702 Patent Costs

7-702.1 General Considerations

A patent for an invention is the government's grant to an inventor of the right to exclude others from making, using, or selling the invention for a 17-year period. Activities involved in getting a patent include searching through prior patents to determine whether the invention, or something similar to it, has already been patented; preparation of an application for the patent to the Patent and Trademark Office of the Department of Commerce; and prosecution (follow-up) of the application until the patent is granted or rejected.

a. FAR Part 27 and DoD FAR Supplement Part 227 establish DoD's policy with respect to patents. Contracting officers implement the policy by inserting one of the clauses set forth in FAR 27.303 into research and development contracts. Each of the clauses provides that the government will obtain title to, or royalty-free use of, "subject inventions."

b. A "subject invention" (which is defined in the clauses) is one that is conceived or first actually reduced to practice under the contract.

c. FAR 31.205-47(f)(6) states that the cost of patent infringement litigation is unallowable unless otherwise provided for in the contract.

d. FAR 31.205-30 governs the allowability of the costs of obtaining patents. Costs incurred on patents to which the government obtains title or royalty-free license are allowable to the extent that they are incurred as requirements of a government contract (see FAR 31.205-30(a)). Also allowable are general counseling services relating to patent matters, such as advice on patent laws and regulations (see FAR 31.205-30(b)).

e. Other than those for general counseling services, patent costs not required by the contract are unallowable (see FAR 31.205-30(c)). Under CAS 405.40(a) such costs, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from billings, claims, and proposals.

f. Frequently, unallowable patent costs are not segregated in the contractor's accounting system. In these cases, CAS 405.50(a) and (b) permit the use of less formal cost accounting techniques. These less formal techniques may use backup data and working papers to establish adequate identification of all costs including unallowable cost and should be maintained for audit verification.)

7-702.2 Patent Costs/Income Related to Small Business and Nonprofit Organizations

a. The Department of Commerce Patents, Trademarks, Copyrights, 37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines on inventions made by small business firms and nonprofit organizations, including universities under funding agreements with Federal agencies.

b. After payment of expenses (including payments to inventors) incidental to the administration of subject inventions, any royalties and/or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-703 Royalties

7-703.1 Royalty Charges

Contractors are required to submit with their proposals under any negotiated contract in excess of \$500,000 (see FAR 15.804-2(a)(1)(i)) detailed information on all royalty costs of more than \$250 which are included in the proposal (see FAR 15.804-6(b)(2) Table 15-2). The contracting officer is responsible for determining that royalties in excess of \$250 charged directly or indirectly to government contracts have been reported under

the provisions of FAR 27.204-1 to the appropriate government office. This allows the government to determine whether or not the royalty charges are excessive, improper, or inconsistent with any license or right to an invention which the government may have acquired under government-sponsored research. In accordance with these determinations, the auditor should assure that improper direct or indirect charges for royalties are disapproved when claimed under cost-type contracts or questioned in advisory reports submitted for negotiation purposes.

7-703.2 Unpaid Royalties

a. DCAA has found cases where contractors included royalty charges in the costs used to negotiate contract prices but subsequently did not have to pay them in whole or in part. Such royalty charges are considered recoverable when (1) a contractor finds that it has been released from obligations to pay royalties (that is, when such release is the result of government antitrust actions against the patent holders) or (2) the royalty estimates are overstated or are based on items that are not subject to royalties (see FAR 27.206-1).

b. In some instances contracts contain recapture provisions to become effective in the event actual royalty payments are less than those estimated and included in the negotiated prices. Other contracts contain no specific provisions for the recovery of unpaid royalties. FAR 27.206-1 provides guidance for determining when royalty escrow or recapture

provisions are appropriate for inclusion in a contract.

c. DCAA auditors will insure that audit programs provide for periodic review of a contractor's accrued royalty accounts to determine the nature and validity of unpaid royalties. DCAA auditors will take the following minimum steps:

(1) Ascertain that contracts are complying with contract provisions that require the submission of reports of royalties paid or payable under the contract.

(2) Examine royalty reports submitted to contracting activities, to confirm the accuracy of the royalties reported as paid, or due to be paid, and the adequacy and timeliness of refunds made under contracts containing either escrow or recapture provisions.

(3) Determine the propriety of retention by the contractor of unpaid royalties if the terms of the contracts or the equities of the situation indicate that the government is entitled to refunds or credits for any part of such unpaid royalties.

7-703.3 Royalty Income—Small Business and Nonprofit Organizations

a. 37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines with respect to inventions made by small business firms and nonprofit organizations including universities, under funding agreements with Federal agencies. Any royalties and or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-800 Section 8 — Labor Settlement and Strike Period Costs

7-801 Introduction

This section provides audit guidance in determining acceptable labor settlement costs and public policy as to the acceptability of strike period costs.

7-802 Labor Settlement Costs

Labor settlement costs (awards) can arise from judicial orders, negotiated agreements, arbitration, or an order from a Federal agency or board. The awards generally involve a violation in one of three areas: (1) Equal Employment Opportunity (EEO) laws, (2) union agreements, and (3) Federal labor laws.

7-802.1 Types of Awards

a. The award can be for compensatory damages, punitive damages, or underpayment for work performed, or it can involve fines and penalties. A settlement may include one or more of these type costs. FAR 31.205-15, Fines and Penalties, provides that any fine or penalty assessed would be expressly unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

b. FAR 31.205-6(k) defines deferred compensation as an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt of compensation by the employee. Subject to FAR 31.205-6(a), deferred awards are allowable when they are based on current or future services. However, awards made in periods subsequent to the period when the work being remunerated was performed are not allowable.

7-802.2 Case by Case Determination

a. The allowability of settlement costs associated with other areas should be determined on a case-by-case basis after considering the surrounding circumstances; i.e., the auditor should look behind the settlement and consider the causes. If the dispute resulted from ac-

tions that would be taken by a prudent businessman (FAR 31.201-3), the costs would be allowable. However, if the dispute was occasioned by actions which appear unreasonable or were found by the agency or board ruling on the dispute to be caused by unlawful, negligent, or other malicious conduct, the costs would be unallowable and, should be questioned.

b. Allocability of these costs must be reviewed (see FAR 31.201-4). For CAS-covered contracts, the provisions of CAS 406.40(b) regarding treatment of prior period adjustments must be considered in determining the treatment of allowable backpay awards. As with other items of cost, if the amount of the award is not material, it can be treated as an indirect cost of the period incurred.

(1) Where the violation which gave rise to the award can be identified to a specific contract(s), the entire award should be charged to that contract(s). The cost would not be allocable to any other contract and should not be included in an indirect cost pool. However, when the contract(s) which gave rise to the award is closed, consideration should be given to including the award in an indirect cost pool provided that the amount charged to government contracts is no greater than that which would have been charged to the government if the contract(s) was open.

(2) Other points to be considered are: (a) when the award is for work performed by direct employees, it may impact not only direct costs, but also indirect costs due to the increase in the allocation base, (b) when a negotiated union contract calls for a retroactive increase, the additional costs should be charged to the same final cost objectives that the actual work performed was charged.

(3) Very often there is a substantial time between when a suit is filed and payment of the award. An inequitable allocation to government flexibly priced contracts would result where indirect employees are involved and there has been a substantial change in the flexible contract mix in the interim period. For

example, if government flexibly priced contracts represented 10 percent of a firm's business at the time the suit was filed, the government should not be expected to pay more than 10 percent of the ultimate award.

7-803 Strike Period Costs

FAR does not provide specific guidance with respect to the allowability of costs during strike periods. Underlying this matter are considerations of public policy, and the difficulties that would be encountered in any attempt to provide adequate coverage for the differing situations frequently precipitated by strikes. As a result, the allowability of costs during strike periods shall be considered on an individual case basis.

a. FAR 22.101-1(b) states that "Agencies shall remain impartial concerning any dispute between labor and contractor management and not undertake the conciliation, mediation, or arbitration of a labor dispute." FAR 22.101-2(b) provides that in the event labor disputes give rise to work stoppage, "Contracting officers shall impress upon contractors that each contractor shall be held accountable for reasonably avoidable delays." "All costs incurred during strikes shall be carefully examined to ensure recognition of only those costs necessary for performing the contract in accordance with the Government's essential interest." (see FAR 22.101-2(c)).

b. Strike period indirect costs included in contractors' cost representations

should be identified and segregated into the following categories to facilitate a determination as to allowability, allocability and reasonableness of the costs:

(1) Costs directly attributable to the strike, which would not have been incurred otherwise, such as extra security guards, special legal expense, arbitration costs, etc.

(2) Costs which were abnormally higher during the strike period, such as recruitment, training of new employees, etc.

(3) Audit determination of indirect costs of a continuing nature, such as cost of normal plant maintenance, depreciation, rent, other fixed charges, supervisory and administrative personnel, etc., will depend on reasonableness, within the framework of existing circumstances with respect to the strike; the extent to which subsequent production makeup operations were undertaken to maintain production schedule; the action taken by the contractor to minimize costs during the period; and such other factors as have a bearing on the expeditious settlement of the dispute.

c. Allocating indirect costs during a strike period to a contractor's commercial or defense work may consider the total period covered by the labor agreement signed at the conclusion of the strike as the basis for allocating strike period costs. Where, for example, a 3-year labor agreement is reached, a proration or amortization of strike period costs over production during the next three years may be appropriate.

7-900 Section 9 — Employee Training and Educational Costs

7-901 Introduction

This section pertains to the employee training and educational cost principle in FAR 31.205-44. The allowability of other types of training and educational costs will be determined on a case-by-case basis in accordance with FAR 31.204(c).

7-902 Differentiation of Types of Training Programs

FAR 31.205-44 treats separately the costs of (1) vocational training at a non-college level, including on-the-job, classroom, and apprenticeship training, designed to increase the vocational effectiveness of employees; (2) part-time college education at undergraduate and postgraduate levels; (3) full-time education at post graduate level; and (4) specialized programs of executive and managerial training, such as OMB courses, industry seminars, etc., for bona fide employees of the contractor. There are important differences among these four kinds of training and education in terms of objectives and specific limitations on allowable costs. It should be noted, however, that the cost principle is not designed to limit the allowability of reasonable costs of orienting an employee in the various facets of a job to which he or she is newly assigned.

7-903 General Audit Considerations

a. Training programs vary from contractor to contractor, depending on the relative need for training, training objectives, the size, stability and composition of the work force and other such factors. Where training is a continuous rather than a spasmodic activity, involves a substantial number of employees, and results in allocation of significant amounts of costs to government work, the contractor should be required to maintain a well-defined training program based on formal policies and procedures. The policies and procedures should be compatible with the accounting system

used to record and distribute costs to cost objectives.

b. Initial audit effort should be directed towards evaluating the contractor's training policies and practices, as well as the related cost accounting procedures. Where the training program is extensive and government work absorbs a significant portion of the total costs, technical assistance should be obtained through the Administrative Contracting Officer if it may be helpful in evaluating the scope and effectiveness of the program. Costs of the program should be recorded in a manner to facilitate determination of the amount allowable in accordance with the cost principle, supplemented by the provisions of the advance agreement where applicable. A training manual is maintained by most major contractors. This manual should prove useful to the auditor in reviewing the company's criteria for determining employee eligibility and need for specific training courses or activities.

c. Each assignment should evidence that the employee is both eligible and requires the education or training to which he or she has been assigned. The contractor should also be expected to monitor the program to assure regular attendance and adequate course performance by the personnel enrolled. The program should include procedures for evaluating the suitability and sufficiency of each course of study or activity. Systematic post-training observation by the contractor of trainees' progress on the job would assist in achieving this objective.

d. Costs of training materials and textbooks are allowable at each of the training levels covered in FAR 31.205-44. Such items are considered to represent those prescribed for use in each course of study or training activity.

e. The determination as to whether a course of study is of college level or non-college level, or whether it is part-time or full-time, must be made for the purpose of determining which provision ((b), (c), (d), or (e)) of FAR 31.205-44 is applicable under any set of conditions. "College level" is not governed by whether a

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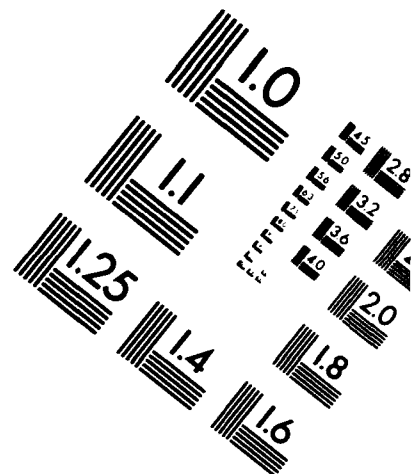
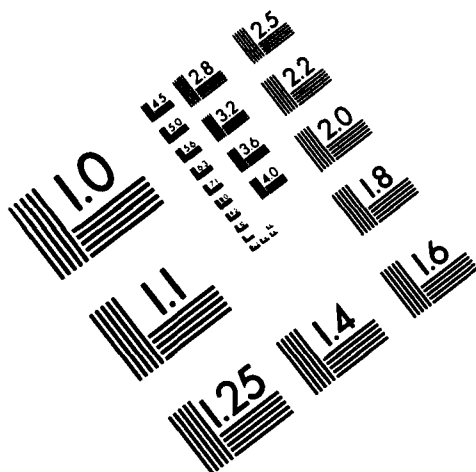




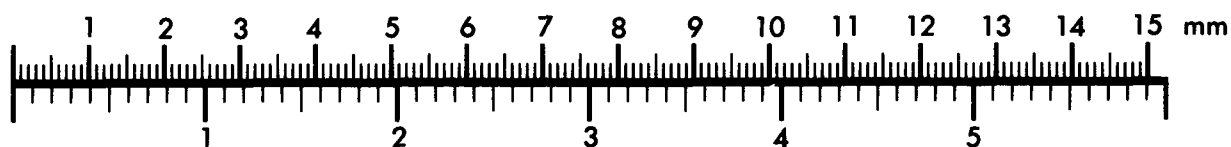
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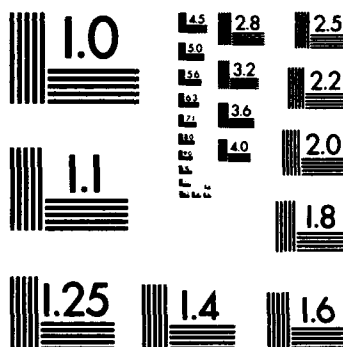
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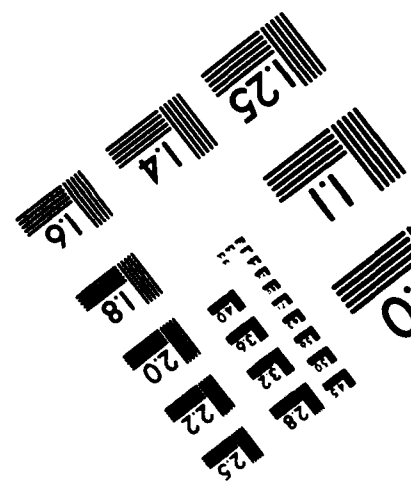
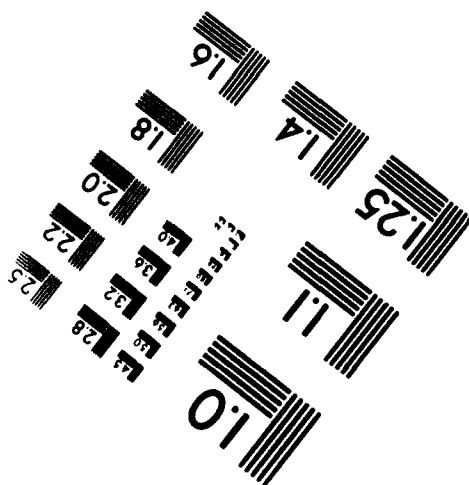
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college credit is granted or available upon successful completion of the course of study; course content and prerequisite requirements are controlling. As between "part-time" and "full-time" college level education, two conditions must be satisfied to support a determination that the education is "full-time." First, the period of study must be equivalent to that of a semester or other recognized period of instruction into which the academic year of an education institution is normally divided. Second, the trainee or student must be in full-time attendance (as that term is defined by the college involved), during otherwise regular working hours, for the duration of the course of study. If either of these conditions is not met, then the college level education should be considered "part-time" under FAR 31.205-44(c).

f. Auditors should evaluate contractors' training policies and practices to insure that contractors who provide full reimbursement of tuition have a policy that prevents recipients from receiving reimbursement from both contractors and other outside sources. (For example, even though college tuition reimbursement for veterans would be allowable under FAR 31.205-44, it is not reasonable for a veteran to receive reimbursement for training cost from the Veterans Administration in addition to that granted by an employer. Therefore, that portion of college tuition reimbursement for veterans (excluding the veterans contributions) that would amount to a reimbursement duplication should be questioned based on reasonableness (see FAR 31.201-3).

7-904 Special Provisions of FAR 31.205-44

a. By provision of FAR 31.205-44(c)(4), straight time compensation of an employee is allowable up to a maximum of 156 hours per year for time spent in part-time college level education during working hours. However, allowability is restricted to cases where circumstances do not permit the operation of classes or attendance at classes after regular working hours. Where the incidence of these costs is high, the auditor should assure

himself or herself that circumstances do not in fact permit holding classes or attending classes after regular working hours.

b. FAR 31.205-44(d) establishes the cost principle for full-time education at a postgraduate (but not undergraduate) college level. Costs are allowable only when the course or degree pursued is related to the field in which the employee is working or may reasonably be expected to work and are limited for each employee to a total period not to exceed two school years or the length of the degree program, whichever is less. In instances where costs for a period in excess of two school years are claimed, and the contractor has not obtained an advance agreement pursuant to FAR 31.205-44(h), such costs should be questioned. Allowable costs consist of tuition, fees, training materials, and textbooks; but not subsistence, salary, or any other emoluments.

c. The auditor should determine that the training and education function does not discriminate against government business or result in undue charges to government contracts. This would occur, if, for example, a company regularly hired new employees in its government-oriented divisions, charged their training costs thereto, and then transferred the trained employees to their commercial oriented divisions. Training and educational costs should properly be charged or allocated on a benefit basis. Such benefit would ordinarily be considered to accrue to the organizational segment(s) or profit center(s) of the company in which the personnel are expected to function (for a reasonable period of time) as a consequence of the training or education provided to them.

d. During their apprenticeship or on-the-job training period, employees may be partially productive. If the degree of such productivity is significant and it can be conveniently and reasonably determined, the amount of such productive work should be charged in the same manner as comparable work performed by other employees. In this case, only the balance between total compensation and the amounts so charged would represent training cost. Where it is not practicable to account for apprenticeship or on-the-

job training, total period costs may be chargeable to the appropriate direct or indirect cost classifications for the work areas involved. (See also 6-204 regarding charges to time and material contracts.)

e. Contractors receiving reimbursement for the costs of certain employees' training under the Job Training Partnership Act should not receive duplicate reimbursement under government contracts. (See 7-1913 for additional guidance.)

f. FAR 31.205-44(h) states that training and educational costs of the type covered in FAR 31.205-44(c) and (d), exceeding those otherwise allowable, may be allowed to the extent negotiated in an advance agreement under FAR 31.109.

However, advance agreements cannot make FAR unallowable costs allowable. To be considered for an advance agreement, the contractor must demonstrate that such costs are consistently incurred pursuant to an established managerial, engineering, or scientific training and educational program, and that the course or degree pursued is related to the field in which a bona fide employee is now working or may reasonably be expected to work. To avoid unnecessary audit work in determining allowable costs, the auditor should review, beforehand, the details of existing or pending advance agreements based on the contractor's demonstration as prescribed in FAR 31.205-44(h).

7-1000 Section 10 — Employee Travel and Relocation Costs**7-1001 Introduction**

a. This section covers basic guidance, including the applicable FAR provisions, in reviewing employee travel costs and travel costs related to contractor -owned, -leased, or -chartered aircraft.

b. Also, presented in this section is audit guidance and applicable FAR provisions in reviewing employee relocation costs.

7-1002 Employee Travel Costs**7-1002.1 General Considerations**

Audits of travel costs (see FAR 31.205-46) should include appropriate examination of the contractor's travel policies and procedures as well as the selective review of individual trips made by contractor personnel. Coverage of this area should thus include a determination that the contractor's travel authorization procedures provide for documented justification and approval of the official necessity of each trip, its duration, and the number of travelers involved. The contractor's procedures should provide for advance planning of travel to assure that (1) wherever feasible and economically practical, required visits to locations in the same geographical area are combined into a single trip, (2) maximum use is made of the lowest customary standard, coach, or equivalent airfare accommodations available during normal business hours, and

(3) coordination between organizational elements is effected to minimize the number of trips to the same location. Individual trips should be reviewed to determine if (1) the contractor is complying with its travel policies and procedures, (2) the trip is for an allowable purpose, and (3) the incurred travel costs are documented and allowable in accordance with FAR 31.205-46. In addition, the auditor should review the contractor's accounting procedures to determine whether or not they provide adequate controls for segregating unallowable travel costs.

7-1002.2 Documentation Required by the Internal Revenue Service

Section 274 of the Internal Revenue Code (IRC) requires extensive documentation of travel and entertainment expense in order for these costs to be deductible for income tax purposes. That documentation, which may provide additional information for audits of travel costs, includes the following:

- (1) the amount of the expenditure,
- (2) time and place of the expenses,
- (3) business purpose of the expenditure, and

(4) business relationship to taxpayer of person(s) entertained. This information must be maintained in a book, diary, account book, or similar records. Documentation such as cancelled checks, credit card receipts, and hotel bills are to be maintained as corroboration for expenses, but without the diary or similar records, they may not be sufficient support for deductibility.

7-1002.3 Allowability of Per Diem Costs Under FAR 31.205-46

a. The Federal Civilian Employee and Contractor Travel Expense Act of 1985 (P.L. 99-234) revised FAR 31.205-46, Travel Costs, to limit reimbursable travel per diem costs to the contractor to the rates and amounts applicable to government employees. The revised rule took effect in FAC 84-19 and is applicable to contracts resulting from solicitations issued on or after 31 July 1986. However, a class deviation was granted for delayed effectivity of the revised rule provided that the ACO obtain the contractor's agreement to apply the new rule to all contracts (whether they are subject to the new rule or not) beginning no later than 1 January 1987. This deviation is intended to provide the contractor with additional time to implement appropriate procedures to comply with the new rule. Allowability of per diem costs under the revised rule follows.

b. FAR 31.205-46(a) states that costs for lodging, meals, and incidental expenses may be based on (i) per diem, (ii) actual expenses, or (iii) a combination of

7-1002.3b.

a fixed amount and actual expenses. However, except for special or unusual situations, allowable costs are limited on a daily basis to the "maximum per diem" rates in effect at the time of travel set forth in the government travel regulations as follows:

(1) Federal Travel Regulations, for travel in the conterminous 48 United States.

(2) Joint Travel Regulations, for travel in Alaska, Hawaii, the Commonwealth of Puerto Rico, and territories and possessions of the United States.

(3) Department of State Standardized Regulations, Section 925, Maximum Travel Per Diem Allowances for Foreign Areas, for travel to foreign countries.

c. All provisions of the referenced government travel regulations are not applicable to travel costs incurred by contractor personnel. The requirements and provisions of the government travel regulations are to be applied to contractors in the following three specific areas:

(1) Definitions of lodging, meals, and incidental expenses. Incidental expenses include fees and tips to waiters and porters; laundry, cleaning and pressing of clothing; transportation between places of lodging or business and places where meals are taken; and telephone calls to reserve lodging accommodations.

(2) Maximum per diem rates. Maximum per diem rates are a combination of lodging plus meals and incidental expenses. The government travel regulations provide for two ceiling amounts: one for lodging and one for meals and incidental expenses. However, contractors are subject to only one ceiling, a total of lodging plus meals and incidental expenses.

(3) Special or unusual situations. Part 8 of the Federal Travel Regulations provides for special or unusual situations where reimbursement of a higher amount (e.g., up to 50 percent above the applicable maximum per diem rate for domestic travel) is authorized based on actual expenses incurred. Examples of such situations include when: (a) the employee must stay at a prearranged hotel where he or she attends a conference or training session; and (b) the travel is to an area where subsistence costs have escalated

for short periods of time during special functions or events such as sports events, world fairs, or conventions.

d. The contractor may adopt policies for reimbursing employees for travel expenses based on actual expenses, fixed amount, or a combination of actual expenses (e.g., for lodging) and a fixed amount (e.g., for meals and incidental expenses). In any event, allowable costs to government contracts may not exceed the maximum per diem rates specified in the government travel regulations. If a contractor's policy is to reimburse its employees a fixed amount (per diem) for subsistence within the prescribed maximum daily per diem rates, there is a presumption that the costs are reasonable and allowable and detailed receipts or other documentation are not required to support claims by employees. On the other hand, if a contractor's policy is to reimburse its employees actual expenses incurred, all unallowable costs (such as, alcoholic beverages and entertainment) must be separately identified and excluded from billings, claims, and proposals to the government in accordance with FAR 31.201-6 and CAS 405.

e. The maximum Federal per diem rates reflect allowance for lodging, meals, and incidentals for a 24-hour period. Use of those rates when travel does not require a full day or does not require lodging expense would be inconsistent with the rate structure. While the cost principle does not prescribe a specific reduction formula for contractor use to account for partial days, it was clarified to expressly state that use of the maximum rates in such situations would generally be unreasonable. Contractors must provide for a reasonable reduction from the maximum rates when lodging, meals, or incidentals are not required.

7-1002.4 Use of Statistical Sampling to Segregate Unallowable Costs

a. When employee reimbursement for travel expense is based on actual costs incurred, FAR 31.201-6 and CAS 405 require contractors to demonstrate that all unallowable costs are separately accounted for and excluded from all billings, claims, and proposals to the government. The use of a statistical sampling

analysis to segregate unallowable costs would not generally meet the requirements of the CAS and the FAR. CAS 405.50(a) and (b) and FAR 31.201-6(c) require contractors to establish and maintain sufficient detail and depth of records of identified unallowable costs so as to permit audit verification of the accounting treatment for the unallowable costs. The use of a projection or estimate of unallowable costs in lieu of specific identification of such costs, even though based on a valid statistical sampling analysis, normally would not be compliant with the requirements of CAS 405.50(a) and (b) and FAR 31.201-6(c).

b. In circumstances where costs involved are not material, CAS 405.50(c) provides that the government and the contractor may reach an agreement on an alternate method in lieu of specifically identifying unallowable costs. In evaluating the contractor's submission for the use of an alternate method of identifying unallowable costs, consider such factors as materiality of unallowable portions of per diem costs and additional administrative costs required to specifically identify such unallowable cost. Consider, for example, a situation such as a corporate home office of a contractor whose government work represents only a minimal portion of its total business. The requirement to specifically identify and segregate all unallowable per diem costs could cost significantly more than the cost of the unallowable items. If the contracting officer agrees that an alternate procedure would be advantageous to the government, the contractor may use statistical sampling or other appropriate methods to estimate the unallowable costs. If a circumstance warrants the use of statistical sampling analysis to estimate the unallowable travel costs, auditors must ensure that proper sampling techniques are used.

7-1002.5 Allowability of Airfare Costs

a. Allowable airfare costs are limited to the lowest customary standard, coach, or equivalent airfare offered during normal business hours, except for special circumstances set forth in FAR 31.205-46(d). As a result of deregulation of commercial airfare, the airlines have introduced nu-

merous airfare rates. With this multiplicity of airfares, the traditional distinction between first-class and coach accommodations has become inadequate for contract costing purposes. Accordingly, FAR 31.205-46 has been revised to specify that the baseline for determining reasonable and allowable airfare is the lowest fare class regularly offered during normal business hours. This fare class is often referred to by fare designations such as class "K Thrift," class "S Standard," and class "Y Coach Economy," depending on the airline.

b. A "business class" accommodation which is offered at a price slightly lower than the first-class fare does not meet the FAR criteria for reasonableness and allowability. Conversely, use of special discount, excursion, or night rates as a matter of common practice should not be required when use of such fares is impractical for business travel purposes, results in circuitous routing, or causes travel accommodations not reasonably adequate for the physical needs of the traveler.

c. Whenever the contractor is able to obtain special fares (Ultra Savers, Ultimate Super Savers, etc.) in lieu of full economy fares, the resulting cost savings should be reflected in any billing, claim, or proposal submitted by the contractor. Travel agencies often prepare and provide to their customers airline cost savings reports designed to attract and retain customers. In connection with forward pricing, the auditor should review any recent savings reports to make sure that the proposed airfare costs reflect appropriate savings. Alternatively, at contractor locations where travel costs are significant, the auditor should recommend that the contractor develop a decrement factor to be applied when basic cost estimates are based on full economy fares rather than achievable, lower special fares.

d. Increased competition among airlines has resulted in certain airline companies offering various promotional benefits including cash, merchandise, gifts, prizes, bonus flights, reduced-fare coupons, upgrade of service, membership in clubs, check-cashing privileges, and free vacations. Contractors are not required

to collect airline promotional benefits from their employees. It is up to each contractor to establish its own policy addressing the treatment of these promotional benefits. However, if a contractor has a policy that results in its employees turning in the frequent flyer bonus credits for company use, then the auditor should ensure that the government receives its applicable share of any credits actually received by the contractor. In those instances where contractors have executed agreements with individual airlines for discounts and bonuses, auditors should determine that appropriate credits or cost reductions are being reflected in forward pricing and actual costs submissions, and that appropriate use of the agreement is being made.

7-1003 Travel Costs, Contractor-Owned, -Leased, or -Chartered Aircraft

7-1003.1 General Audit Considerations

a. FAR 31.205-46(e) sets forth principles and criteria for determining the allowability of costs incurred in the operation and maintenance of contractor-owned, -leased, or -chartered aircraft (collectively referred to as private aircraft).

b. As a general rule, travel costs via private aircraft in excess of the standard commercial airfare are unallowable. Exceptions to this general rule are described in 7-1003.2. The use of private aircraft generally results in higher costs than travel by commercial airlines or other modes of transportation.

7-1003.2 Conditions for Allowability of Contractor-Owned, -Leased, or -Chartered Aircraft

a. As a prerequisite to allowability, the contractor must maintain and make available to the government full documentation in support of the costs including the manifest/log for all flights (see 7-1003.6). If the contractor fails to maintain required documentation or refuses to provide such documentation, the auditor should disallow costs in excess of otherwise allowable standard commercial airfare.

b. Travel costs via private aircraft in excess of the standard commercial airfare are allowable in two situations: (1) when travel by such aircraft is specifically required by contract specification, term, or condition; or (2) when a higher amount is approved by the contracting officer.

c. All or part of excess costs incurred for operating private aircraft may be approved by the contracting officer: (1) when one or more of the conditions described in FAR 31.205-46(d) are present that would justify costs in excess of the lowest standard commercial airfare, such as requiring circuitous routing, travel during unreasonable hours, or excessively prolonged travel; or (2) when an advance agreement has been executed.

7-1003.3 Use of Advance Agreements

a. When the contractor proposes an advance agreement with respect to the costs of company aircraft, the auditor should evaluate the contractor's proposal and provide audit findings and recommendations to assist the contracting officer in establishing the negotiation objective. The auditor should request technical assistance in areas such as the size, type, and number of aircraft; safety factors; and other technical requirements of aircraft.

b. In evaluating the contractor's proposal, the auditor should consider major financial and nonfinancial factors. Generally, the contractor must demonstrate that scheduled commercial airline service is not readily available at reasonable times to accommodate the company's air travel requirements. In addition, proximity of commercial airports to the contractor's location as compared to private air fields that are used, or are intended to be used, is also a factor in conjunction with any time savings of key personnel. Increased flexibility in scheduling flights may result in time savings and more effective use of personnel. However, the auditor should be mindful that a contractor in the normal course of conducting its business seldom needs corporate aircraft and that the convenience of corporate aircraft should not be a substitute for the economy of commercial flights. While there may be critical or emergency situa-

tions that cannot be effectively handled by commercial flights, such situations generally occur so infrequently that they do not justify the long-term use of corporate aircraft. It is the contractor's responsibility to justify and demonstrate that the need for corporate aircraft truly outweighs cost savings arising from the use of commercial airlines.

c. The ASBCA ruled (in the General Dynamics case no. 31359, 92-2, BCA 24922) that "time savings, productivity gains, or more effective use of personnel" can be used to demonstrate and justify the higher cost of private aircraft. It is the contractor's responsibility to provide the government a fully supported submission to demonstrate that these savings exceed the costs of using private aircraft as compared to using commercial airlines. The ASBCA also ruled that it is appropriate for the contractor to consider the value of executive time in the cost-benefit analysis. The ASBCA accepted the concept that the calculation of the value of the executive's time could include an estimate of the executive's value to the corporation in addition to the executive salary and fringe benefits. The ASBCA referred to the estimate of the executive's value to the corporation as a "multiplier." The use of a multiplier by the contractor should not be accepted solely as a result of the ASBCA case. The contractor must provide supporting data to justify any proposed multiplier. If the contractor does not justify the use of a multiplier, the related costs should be questioned.

d. The costs associated with private aircraft flights should be allocated to all passengers. The information listed in 7-1003.6 is required by the cost principle to determine if unallowable trips such as spousal travel have been identified and all allocable costs to the unallowable trips were excluded from reimbursement by the government. The auditor should recommend that the advance agreement state that unallowable passenger trips be allocated their fair share of costs and these costs should be excluded from requests for reimbursement by the government.

e. In situations where the contractor's proposal includes acquisition of an air-

craft, either through purchase or capital lease, the auditor should carefully review the feasibility studies the contractor has made in advance of acquiring the aircraft, justification presented to the approving authorities within the company, the contractor's decision, and the implementing procedures adopted. Corporate aircraft costs, once the purchase or capital lease is made, are very much like sunk costs and cannot be rapidly altered by management decision. It is particularly important for the auditor to recommend that the contracting officer not approve the proposed acquisition of the aircraft unless the contractor can demonstrate the cost-effectiveness of corporate aircraft.

7-1003.4 Reasonableness of Contractor-Owned, -Leased, or -Chartered Aircraft Costs

a. In situations where all or part of travel costs via private aircraft in excess of the standard commercial airfare are approved by the contracting officer (see 7-1003.3), such costs are subject to the determination of reasonableness and allocability. Costs of private aircraft include costs of lease, charter, depreciation, operation (including personnel), maintenance, repair, insurance, and all other related costs.

b. A corporate aircraft is sometimes used for nonbusiness or otherwise unallowable activities. The contractor is required under CAS 405 and FAR 31.201-6 to identify all unallowable costs. The auditor should review the flight manifest/log to determine whether the contractor has excluded the amount allocable to any travel for nonbusiness or otherwise unallowable activities. If the trip is considered unallowable, the auditor should calculate the related unallowable aircraft costs considering the entire costs of the aircraft — both fixed and variable costs.

c. The size, type, and number of aircraft maintained or chartered are major considerations in evaluating the reasonableness of the costs involved. The auditor should also review the flight manifest/log and other available documentation to determine whether optimum use is made of such aircraft to the extent that they are used for all suitable trips except

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where the variable costs involved in their use would exceed the trip cost by commercial airline.

d. Depreciation often represents the major item of contractor-owned aircraft costs. In evaluating it, the auditor should ensure that the allowable amount is determined in accordance with the provisions of FAR 31.205-11. Supplemental audit guidance on depreciation is at 7-400. Costs of aircraft overhaul and major component replacement, and their accounting treatment, also merit close audit scrutiny. If such costs are not capitalized and amortized by the contractor but are expensed in the period they are incurred, the auditor should assure that the procedure does not result in distorting the total aircraft costs for the period involved. Any gain or loss on the disposition of contractor-owned aircraft should be accounted for as provided in FAR 31.205-16.

e. Audit of private aircraft costs should include the evaluation of the propriety of the method used for their assignment or allocation to government contracts. When an aircraft is used exclusively by a particular organizational element, such as by the home office, division, or plant, the costs of the aircraft should be charged to that entity. When use is broader based, the aircraft costs should be distributed equitably to all of the user units. Some contracts may provide for travel costs as direct charges. In these cases, the auditor should assure that similar type costs are not duplicated as part of the allocation of aircraft costs to these contracts through overhead. Aircraft may also be used for non-travel purposes, such as instrument testing. Applicable costs should be charged directly to the benefiting projects.

7-1003.5 Contractor Responsibility

FAR 31.205-46(e)(2) specifically requires that the contractor must maintain documentation of all travel via private aircraft as a prerequisite of consideration for allowability of such costs. The contractor has the responsibility to support and justify the cost of aircraft usage. This responsibility includes: (1) identification of all costs associated with private aircraft, (2) submission of a comparative

analysis of costs of private aircraft and standard commercial airfares, and (3) maintenance of a flight manifest/log. Costs that are unsupported as a result of a contractor's inability or unwillingness to furnish the required documentation should be disallowed.

7-1003.6 Maintenance of a Flight Manifest/Log by Contractor

The flight manifest/log which the contractor is required to maintain, plus other necessary backup data, should be in sufficient detail to serve as a source of support for its proposed costs. At least the following information for each flight should be provided:

- (1) Date, time, and point of departure (airport).
- (2) Date and time of arrival, and destination (airport).
- (3) Names of pilot and crew.
- (4) For each passenger aboard:
 - Name.
 - Name of company or organization represented.
 - Position held in company or organization.
 - Authorization for trip.
 - Purpose of trip.

7-1004 Employee Relocation Costs**7-1004.1 General**

a. The cost principle for allowability of relocation costs is FAR 31.205-35. It defines relocation costs as costs incident to the permanent change of duty assignment (for an indefinite period or for a stated period of not less than 12 months) of an existing employee or upon recruitment of a new employee. Relocation costs are usually comprised of (1) cost of travel and transportation of household goods for the employee and immediate family members, (2) cost of advance trips to find a permanent residence, (3) closing costs (including state and local transfer taxes) incidental to sale of prior residence, (4) miscellaneous expenses such as the costs of cancelling an unexpired lease and disconnecting and reinstalling appliances, (5) costs for acquisition of new house, (6) continuing mortgage interest at the old residence, (7) interest differential

between the old and new mortgage and rental differential payments where the relocated employee retains ownership of a vacated home in the old location and rents at the new location, and (8) other miscellaneous expenses. Costs of travel for the employee and the employee's family to the new duty station and for house hunting trips include per diem costs which are also subject to FAR 31.205-46. (See 7-1002.3.)

b. The costs of relocating an employee are generally substantial. Evaluation of the contractor's policies and procedures as well as employment agreements as to reasonableness and compliance with FAR requirements is an important step of any audit program when significant costs are charged to government work. The allocation methods should be reviewed to determine that proper costs are being charged to benefiting contracts. In this regard, relocation costs should generally be charged to the receiving segment. Tests of individual personnel actions should be included to determine if established practices are being followed. When the contractor's policies and procedures are inadequate to control the incurrence of and accounting for unallowable costs, individual voucher testing must determine if the costs are allowable in accordance with FAR 31.205-35.

7-1004.2 Conditions for Allowability of Relocation Under FAR 31.205-35

a. The contractor's relocation costs must be reasonable and allocable, and must meet the four criteria listed in FAR 31.205-35(b) to be allowable. FAR 31.205-35(a) lists specifically allowable relocation costs and 31.205-35(c) lists specifically unallowable costs.

b. Allowable relocation costs for an existing or new employee must involve a permanent change of duty assignment. Any such relocation for an indefinite period qualifies, but one for a stated period of less than 12 months does not. Relocation assignments for stated periods or for indefinite periods should normally last at least 12 months. When an undue number of such relocation assignments are terminated or completed in less than 12 months, the auditor should evaluate the reasons and recommend

remedial action if appropriate. Relocation costs in excess of constructive temporary duty assignment costs should be questioned if the contractor should have known at the time of the assignment that it would not continue for a period of 12 months or more.

c. Failure to fulfill a permanent change of duty assignment agreement for reasons within the employee's control requires the contractor to refund or credit the relocation costs to the government. The auditor should encourage contractors to include recapture provisions in relocation agreements if this is not a practice. The provision should then be monitored by the auditor to assure that an adequate contractor follow-up system is in place to collect refunds when appropriate. The auditor should assure that a proper portion of any such refunds is credited to the government.

d. The recapture rule is not applicable to return relocation costs of a new employee who: (1) is hired specifically for a long-term (at least 12 months) field project or contract assignment; (2) is entitled to return relocation under the terms of his or her employment contract; and (3) is not a permanent employee and is released from employment upon completion of the assignment for which he or she was hired. This exception is applicable to only those employees who meet all three requirements. Accordingly, it is not applicable to the existing employees who are reassigned to field projects.

7-1004.3 Applicability of Joint Travel Regulations (JTR) to Relocation Per Diem Costs.

The FAR 31.205-46 allowable maximum government travel regulation per diem rates for lodging, meals and incidental expenses apply to contractor employees while traveling on official company business. Househunting trips and travel to the new duty station are considered official business travel and subject to the FAR 31.205-46 per diem criteria. This criteria does not apply to temporary quarters allowances because the employee is not considered to be on official business travel while in temporary quarters.

7-1004.4**7-1004.4 Employee Assignments not Covered by the Relocation Cost Principle**

Certain duty assignments, principally overseas locations, are accompanied by "location allowances." These "location allowances" represent compensation in addition to normal wages and salaries that are paid by contractors to induce employees to undertake or continue work at locations which may be isolated or in an unfavorable environment. Such allowances do not constitute relocation costs covered by FAR 31.205-35. They are considered a part of "compensation for personal services" by provision of FAR 31.205-6. They should be evaluated using the procedures described in 5-1009. Also costs of travel to an overseas location should be considered travel costs in accordance with FAR 31.205-46 and not relocation costs if dependents are not permitted at that location for any reason and the costs do not include costs of transporting household goods. Under these circumstances the move is obviously considered a temporary rather than a permanent change of duty station.

7-1004.5 Unallowable Relocation Costs

Specific types of relocation costs are not allowable, should not be claimed by the contractor, and must be questioned or disallowed by the auditor if proposed or charged under government contracts. FAR 31.205-35(c) lists the types of costs that are not allowable, including (1) loss on the sale of a home; (2) continuing mortgage principal (not interest) payments on the residence being sold; (3) certain costs incident to the acquisition of a new home as shown in FAR 31.205-35(c)(2); (4) payment of employee's income taxes or FICA incident to reimbursed relocation costs; (5) payments for job placement assistance to employee spouses; and (6) costs incident to furnishing or obtaining equity, nonequity, or lower-than-market-rate loans to employees. In addition, FAR 31.205-35(d) requires the contractor to refund or credit contract costs for amounts previously charged to relocate an employee if the employee resigns for voluntary reasons within 12 months after relocation. Termination of employment for illness, dis-

abling injury, or death is not generally within the employee's control and, therefore, would not serve as a basis for compelling contractors to refund or credit relocation costs to the government.

7-1004.6 Mass Relocations

a. Large scale or mass relocation of employees may result in abnormal total relocation costs. FAR 31.205-35(e) recognizes that questions may arise as to the reasonableness and allocability of the total amount, even though the items comprising the total are otherwise allowable. Thus FAR 31.109, Advance Agreements, provides the means by which parameters of reasonableness and allocability of special or mass relocation may be agreed upon in advance between the government and the contractor. In absence of an advance agreement, the provisions of FAR 31.2, should be used by the auditor for determination of reasonableness and allocability.

b. If the auditor learns that large scale employee relocations are to be made which may result in significant costs to prospective or existing government contracts, the auditor should report the matter to the cognizant ACO with a recommendation for an advance agreement regarding the allowability of such costs. The recommendation should cite important areas for agreement such as (1) the segments of the company among which the costs are to be equitably distributed, (2) the length of time over which the costs are to be amortized, and (3) the employees eligible for reimbursement of relocation costs. After coordination with the local ACO, the auditor should provide any needed information to other contracting officers who are concerned.

c. Depending on the circumstances, as covered in FAR 31.109, an advance agreement may be negotiated by the local ACO, the CACO, or a PCO. Be responsive to any request from the designated government negotiator for audit assistance in establishing the negotiation objective.

7-1004.7 State and Local Transfer Tax

Some state or local governments may impose taxes on sales of homes. If the tax is imposed on the seller (employee) by

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law, it is considered a form of transfer tax which must be satisfied before the sale can be consummated and would qualify as closing costs described in FAR 31.205-35(a)(3). However, agreement to pay the

tax not imposed on the seller by law, in the interest of making a sale or for other reasons, would not qualify as an item of closing costs and would be unallowable.

7-1100 Section 11 — Dues, Memberships, and Professional Activity Costs

7-1101 Introduction

a. This section provides basic guidance in reviewing dues, memberships, and professional activity costs (FAR 31.205-43).

b. Additional guidance is provided on costs of memberships in industrial liaison programs of universities, the Army, Navy, and Air Force associations, and organizations engaged in lobbying or charitable activities.

7-1102 Dues, Memberships, and Subscriptions

7-1102.1 General

a. Generally, costs of memberships in trade, business, technical, and professional organizations are allowable per FAR 31.205-43(a) but see 7-1102.2, 7-1102.3, and 7-1102.4 below for special considerations.

b. Subscription costs include trade, business, professional, or technical periodicals. Such costs are generally allowable per FAR 31.205-43(b).

7-1102.2 Army, Navy, and Air Force Associations

The Association of the United States Army, Army Aviation Association of America, Navy League of the United States, Air Force Association, and other nonprofit associations with similar objectives have for many years offered memberships to contractors. These associations are primarily concerned with fostering and preserving the images and efficiencies of the Army, Navy, and Air Force. They operate outside government channels in an endeavor to preserve a spirit of fellowship among former and present Service members and to inform and arouse the interests of the public in activities and achievements of their respective military services. Generally, memberships are offered to contractors that wish to support the objectives of these associations. The membership dues often include a subscription to publications issued periodically. For example, the Association of the United States

Army monthly publishes a magazine entitled ARMY. It includes numerous articles primarily designed to enhance Army personnel programs and to promote manpower and combat readiness. In addition, conventions and meetings are periodically held by these associations, at which contractors frequently exhibit their products. Occasionally, these conventions or meetings will be sponsored by a contractor or group of contractors. These conventions or meetings are usually held to focus the attention of the public on the activities of a particular military service that contribute to national defense programs. In determining the allowability of costs incurred by contractors with these associations, the auditor will be guided by the following:

a. Costs related to these associations such as membership fees, exhibit or display costs, and sponsorship expenses do not qualify as allowable under the trade, business, technical, or professional activity principle in FAR 31.205-43.

b. The costs of travel, registration, hotel, and other expenses incurred in connection with these associations' conventions, meetings, and conferences are considered unallowable in accordance with FAR 31.205-43(c), unless the contractor can show that the primary purpose of the meeting is for "the dissemination of technical information or the stimulation of production." The inference here is that the technical information will benefit performance, or stimulate production, under a particular government contract, or series of contracts.

7-1102.3 Costs of Memberships in Industrial Liaison Programs of Universities

Industrial liaison programs are offered to contractors by various universities throughout the country. Under such programs, contractors are usually entitled to the use of university facilities, consultations with faculty members, copies of research reports, attendance at symposiums, and possibly other benefits. To become eligible for such benefits, the universities require that contractors pay

membership fees. Some universities enter into formal agreements with contractors describing the types of benefits that will be provided.

a. The membership fee in each industrial liaison program, as further discussed in b. below, should be considered a retainer fee under FAR 31.205-33 and an allowable cost if supported by evidence that: (1) the services are necessary and customary; (2) the level of past services justifies the amount; and (3) the retainer fee is reasonable compared to the cost and level of expertise required to maintain an in-house capability to perform the covered services.

b. Normally, benefits available from membership in an industrial liaison program are the same for all members, regardless of fee paid by each member. Universities usually set a schedule of fees based on company size which is often based on voluntary compliance or negotiation above the minimum fee. Generally, amounts paid in excess of the minimum fee are voluntary and should be disapproved as contributions under FAR 31.205-8, in the absence of evidence to the contrary. However, a larger company or one with a special need may derive more benefits than other industrial liaison program members. In such cases, all or a portion of the amount above the minimum fee may be allowable.

7-1102.4 Costs of Membership Fees in Organizations Engaged in Lobbying or Charitable Activities

The allowability of membership fees, association dues, or the costs of donated time or materials to any organization can normally be determined from the primary mission of the organization receiving the payments or benefits. We believe that all organizations fit three basic categories and that the allowability of associated costs is predicated on the nature and materiality of expenses.

a. Bona Fide Trade or Professional Organizations

If an organization is formed for the basic purpose of providing technical services to member contractors and the contractors can demonstrate that such services were actually received, the membership and associated costs are normally

allowable, even though the organization may occasionally engage in an immaterial amount of lobbying activities or charitable endeavors.

b. Trade or Nonprofit Organizations Partially Engaged in Lobbying or Charitable Activities

The costs of membership or other support activities donated or supplied to organizations which are partially engaged in lobbying or charitable endeavors should be examined in light of their nature, purpose, and materiality. There is no hard and fast rule to apply to these conditions in order to objectively determine the extent of unallowable costs attributed to association with certain organizations. Therefore the following steps should be taken in order to provide reasonable assurances that unallowable contributions or lobbying costs are not billed or claimed by contractors when they are commingled with other allowable costs:

(1) Question any special assessment or separately identified portion of the costs of membership fees or other type costs applicable to lobbying or charitable activities as unallowable.

(2) Notify the contractor that it is responsible for the identification and removal from its claims and proposals of any unallowable activity costs and that it is required to maintain adequate records to demonstrate that the certification of allowable costs complies with applicable cost principles.

(3) In the absence of documentation as to the amount of unallowable lobbying or charitable activities performed by such organizations, it may be difficult to verify the validity of the contractor's certification or to question estimated unallowable activities. The auditor should request the contractor to obtain from the organization in question a confirmation letter identifying or estimating the amounts or percentages of lobbying or charitable effort expended by the organization in the accounting year under review.

c. Organizations Dedicated to Lobbying or Charitable Activities

When it can be determined that the fees or other type costs associated with membership in these organizations are ultimately expended on lobbying or char-

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itable activities, the costs are to be evaluated for allowability under FAR 31.205-8, 31.205-22, or 31.205-50.

7-1102.5 Costs of Political Campaign Activities at Contractor Facilities

Costs associated with political campaign activities, such as candidates' appearances and speeches at contractor facilities, are unallowable in accordance with FAR 31.205-22(a)(1), Legislative Lobbying Costs, when such activities are clearly an attempt by the contractor to influence the outcome of an election by soliciting votes. The key considerations in this determination are how the candidate is portrayed by the contractor and the subject matter of the candidate's speech. When questioning such an event all costs associated with these activities including applicable burdens should be questioned.

7-1103 Professional Activity Costs**7-1103.1 General**

a. Paragraph (c) of FAR 31.205-43, Trade, Business, Technical and Professional Activity Costs states that the cost of technical or professional meetings and conferences are allowable when the primary purpose of the meeting is the dissemination of technical information or the stimulation of production, provided the costs meet the other requirements controlling allowability (FAR 31.201-2).

b. The cost principle makes the following type of professional and technical activity costs expressly allowable:

(1) Organizing, setting up, and sponsoring the technical and professional meetings, symposia, seminars, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs.

(2) Attending the meetings by contractor employees, including travel costs.

(3) Attending the meetings by individuals who are not contractor employees, provided the costs are not reimbursed to them by their own employer and their attendance is essential to achieve the purpose of the meetings.

7-1103.2 Conference Costs versus Entertainment Costs

a. The term business meetings and conferences refers to both contractor and trade association hosted activities of a purely business nature. Determinations as to whether or not expenses associated with a particular meeting or conference represent allowable business expense under FAR 31.205-43(c) provisions or unallowable social activity under FAR 31.205-14 (Entertainment Costs) should be made on a case-by-case basis, based on all pertinent facts.

b. Under the provision of FAR 31.205-43(c)(3), costs associated with the spouse of an attendee are not allowable because the spouse's attendance is not essential to achieve the purpose of the meeting.

7-1103.3 Documentation

a. Determination of allowability requires knowledge concerning the purpose and nature of activity at the meeting or conference. The contractor should maintain adequate records supplying the following information on properly prepared travel vouchers or expense records supported by copies of paid invoices, receipts, charge slips, etc.

(1) Date and location of meeting including the name of the establishment.

(2) Names of employees and guests in attendance.

(3) Purpose of meeting.

(4) Cost of the meeting, by item.

b. The above guidelines closely parallel the current record-keeping requirements in Section 274 of the Internal Revenue code for entertainment costs as a tax deductible expense. Where satisfactory support assuring the claimed costs are allowable conference expenses is not furnished, the claimed conference/meal costs and directly associated costs (see 8-405.1d. for description) should be questioned.

c. Meal Expense. Expenses for meals of contractor personnel, not in travel status, who act as hosts at contractor-sponsored business luncheons or dinners are allowable if it is determined that the activity constitutes a business meeting or conference associated with the active conduct

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of the contractor's business and not a social function.

**7-1103.4 Standards of Conduct —
Federal Employees**

Guest expenses for meals or other incidentals applicable to Federal employees should normally be questioned as

unnecessary, and hence unreasonable costs, except under limited circumstances, since they are prohibited from accepting gratuities by Executive Order 11222 of 1965, Title 5 CFR 735(c), and various departmental implementing directives (e.g., DoDD 5500.7, "Standards of Conduct").

7-1200 Section 12 — Public Relations and Advertising Costs

7-1201 Introduction

This section provides supplemental guidance on audits of public relations and advertising costs including publications. The guidance in Chapters 2 through 6, 8, and 9 also applies to these areas.

7-1202 Applicability of FAR

Effective 7 April 1986, FAR 31.205-1 was revised to incorporate cost principles on public relations costs. FAR 31.205-1 defines and addresses the allowability of public relations and advertising costs. Prior to April 1986, guidance on distinguishing between public relations and advertising costs and the allowability of public relations costs were based on ASBCA cases.

7-1202.1 Definition of Public Relations and Advertising

Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in the FAR definitions of public relations and advertising.

a. Public Relations

Public relations as defined in FAR 31.205-1(a) means all functions and activities dedicated to:

(1) Maintaining, protecting, and enhancing the image of a concern or its products; or

(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising and customer relations.

b. Advertising

(1) Advertising as defined in FAR 31.205-1(b) means the use of media to promote the sale of products or services and to accomplish the activities referred to in FAR 31.205-1(d) (see 7-1202.2a) regardless of the medium employed,

when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear.

(2) Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, dealer cards, window displays, outdoor advertising, radio, and television.

7-1202.2 Allowability of Public Relations and Advertising Costs

FAR provisions 31.205-1(d), (e), and (f) address the allowability of public relations and advertising costs. These provisions and supplemental audit guidance are provided in the following paragraphs:

a. Advertising Costs

All advertising costs other than those specified in FAR 31.205-1(d) are unallowable. Allowable advertising costs include:

(1) Costs that arise from requirements of government contracts and that are exclusively for:

(a) Recruiting personnel required for performing contractual obligations, when considered in conjunction with all other recruitment costs (but see FAR 31.205-34);

(b) Acquiring scarce items for contract performance; or

(c) Disposing of scrap or surplus materials acquired for contract performance. If incurred for more than one government contract or both government and other work of the contractor, costs of this nature are allowable to the extent that the principles in FAR 31.201-3 (reasonableness), FAR 31.201-4 (allocability), and FAR 31.203 (allocation of indirect costs) are observed.

(2) Costs to promote sales of products normally sold to the U.S. Government which contain a significant effort to promote exports from the United States. See 7-1202.2g

b. Contract Requirements

Advertising and public relations costs specifically required by contract are allowable.

c. Liaison Cost**(1) Allowability of Liaison Costs**

Allowable public relations costs include cost incurred for (a) responding to inquiries on company policies and activities; (b) communicating with the public, press, stockholders, creditors, and customers; and (c) conducting general liaison with news media and government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, and financial information.

(2) Audit Evaluation

(a) Public relations costs may encompass (i) services performed in-house, possibly in a public relations or similarly designated department, by the contractor's own employees; and (ii) services performed by the contractor's own employees at any off-site liaison office. Public relations costs incurred in-house and off-site include the salaries and related travel and fringe benefits of the employees involved and an allocable share of supervision, space, utilities, and administration costs. Audit evaluation of public relations costs should encompass all of the foregoing aspects.

(b) The costs of off-site liaison/public relations offices are often substantial and the contractor's in-house records may not be sufficient to permit the necessary scope of audit of such costs. This condition would call for additional audit effort at the off-site facility to the extent required to determine the allowability, allocability, and reasonableness of the costs incurred by that facility.

d. Community Service Activities

(1) Costs of participation in community service activities such as blood bank drives, charity drives, savings bond drives, and disaster assistance are allowable.

(2) Under FAR 31.205-8, contributions and donations, whether in the form of money, goods, or services, are unallowable. However, the costs of services of executive and other personnel in support of charitable and community funds or other similar campaigns or drives are

allowable under FAR 31.205-1(e)(3) and should not be questioned. When such services affect the concurrent full discharge of their other regular duties and responsibilities to the contractor by the personnel involved, the auditor should consider whether the costs are reasonable.

e. Plant Tours and Open Houses

Costs of plant tours and open houses are allowable; however, costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media are unallowable under FAR 31.205-1(f)(5) (see 7-1202.2i).

f. Ceremonial Costs

Costs of ceremonies such as corporate celebrations and new product announcements are unallowable. Costs of keel laying, ship launching, commissioning, and roll-out ceremonies, to the extent specifically provided for by contract, are allowable.

(1) Ship Launching Ceremonies

Items of cost which are normally acceptable for ship launching ceremonies include (a) the construction of a minimum-size launching platform large enough to accommodate the launching party and speakers; (b) modest decorations of the launching platform and a sponsor's shelter, if needed; and (c) a bottle of champagne, decorative ribbon and suspension, and a simple decorative packing case without metal container.

(2) Sponsor's Costs

Costs related to personal expenses of the sponsor and its party, luncheons or dinners, and gifts for the sponsor are unallowable and should be questioned.

g. Air Shows, Special Events, and Trade Shows

Generally, air shows and trade shows are classified as broadly targeted selling efforts and are covered under FAR 31.205-1. However, the allowability of these costs has been complicated by numerous changes effected through the public laws to the regulations. These costs are classified as allowable or unallowable on contracts depending on when the costs were incurred.

In determining the allowability of air shows, special events, and trade shows auditors must pay specific attention to the contract award date, when the costs

were incurred, and the governmental agency purchasing the goods and services. The chart below assists in identifying the applicable allowability criteria. The numbers are keyed to the following five paragraphs in this subsection. Advertising costs of air shows, special sales events, and trade shows with no foreign sales (export) value have been and still are unallowable costs. Likewise, entertainment costs and other costs not necessary to a sales presentation have always been and still are unallowable. For additional information on the allowability of foreign selling costs, see the chronology presented in 7-1306.2.

Contract Dates	DoD Con- tracts	All Other Govern- ment Con- tracts
5/15/91 - Current	(1)	(1)
4/12/88 - 5/15/91		
Costs incurred on or after the start of the contractor's 1st fiscal year beginning on or after 12/15/88	(2)	(3)
Costs incurred prior to the start of the contractor's 1st fiscal year beginning on or after 12/15/88	(3)	(3)
Prior to 4/12/88	(4)	(5)

(1) Costs of "significant effort" to promote export sale of products normally sold to the U.S. Government are allowable subject to a ceiling. This includes air shows, trade shows, and special events.

(2) (a) For DoD contracts open as of 5/15/91, (1) is retroactively applied to fiscal years beginning on or after 12/15/88.

(b) For DoD contracts open as of 12/15/88 but closed prior to 5/15/91, costs of "significant effort" to promote export sales of U.S. defense industry

products were allowable subject to a ceiling. DoD contracts have specific coverage in the DFARS which is in place of the FAR coverage. The FAR coverage remained applicable to non-DoD contracts as discussed in (3) below. For these DoD contracts, DFARS 231.205-1 and 231.205-38 provided that the costs of activities which contain "significant efforts" to promote exports of U.S. defense industry products are allowable. Such promotional activities primarily targeted at foreign selling are allowable even if they include domestic marketing efforts. Additional information regarding ceiling limitations and the effective dates are in 7-1306.2(d).

(3) The following costs to promote American aerospace exports at domestic and international exhibits, such as air shows, trade shows, and conventions, were allowable provided they were reasonable:

Transportation of the aircraft;
Aerospace parts and equipment;
Other associated support cost.

(a) These allowable costs did not include other exhibit costs (such as cost of entertainment, hospitality suites or chalets, advertising media other than exhibits, and other costs not necessary to establish, operate, or maintain an exhibit, display, or demonstration).

(b) In addition, the allowability coverage was limited to promoting a specific category of products (i.e., American aerospace products) to a specific class of customers (i.e., foreign customers). Accordingly, costs incurred for promoting a contractor's non-aerospace products at an international trade show, and that portion of costs incurred for promoting a contractor's aerospace products to American customers, were unallowable (Section 8062 of the 1988 Appropriations Act).

(4) For DoD contracts awarded prior to 12 April 1988 and completed before the start of the contractor's first fiscal year beginning on or after 15 December 1988, air shows, trade shows, and conventions were generally unallowable. However, for DoD contracts awarded prior to 12 April 1988 and still in progress on or after the start of the contractor's first fiscal year beginning on or after

15 December 1988, air shows, trade shows, and convention costs are generally allowable as described in (1) and (2). On such in-progress contracts awarded prior to 12 April 1988, the costs of air shows, trade shows, and conventions incurred in prior fiscal years remain generally unallowable. This type of change in the applicability of the cost principles based on the timing of cost incurrence is unusual. It was mandated by Public Law 100-456. These costs are allowable subject to a ceiling which is described in 7-1306.2.

(5) For contracts with the U.S. Government other than with DoD awarded prior to 12 April 1988 and completed prior to 15 May 1991, air shows, trade shows, and conventions were generally unallowable. However, for non-DoD contracts awarded prior to 12 April 1988 and still in progress on or after 15 May 1991, air shows, trade shows, and convention costs are generally allowable as described in (1) if incurred on or after 15 May 1991. These costs are allowable subject to a ceiling which is described in 7-1306.2.

(6) Audit Guidance

(a) Contracts awarded in the period discussed in 7-1202.2g(1) & (2) do not require the segregation of promotional costs based on targeted customers. The provisions make allowable significant effort primarily targeting the promotion of exports even though domestic marketing efforts are included.

(b) For all contracts awarded in the period discussed in 7-1202.2g(3) the contractor must be able to document that the products are American aerospace products and that the targeted customers are foreign. Certain trade shows or exhibits target a mixed customer audience (both foreign and American customers). When an event targets both types of customer, only a portion of the costs (those targeting foreign customers) are considered allowable. FAR 31.204, Application of principles and procedures, requires the contractor to assign costs targeting domestic customers as unallowable and costs targeting foreign customers as allowable. The auditor should review the contractor's documentation and assumptions.

h. Meetings, Symposia, Seminars, and Other Special Events

Costs of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production are unallowable.

i. Promotional Material

Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities are unallowable. However, see FAR 31.205-13(a), Employee morale, health, welfare, food service, and dormitory costs and credits; FAR 31.205-21, Labor relations costs; FAR 31.205-43(c), Trade, business, technical, and professional activity costs; and FAR 31.205-44, Training and educational costs.

j. Souvenirs, Models, and Mementos

Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public are unallowable.

k. Costs of Memberships

(1) FAR Provision

Costs of memberships in civic and community organizations are unallowable.

(2) Audit Guidance

Allowable costs of memberships in trade, business, technical, and professional organizations (FAR 31.205-43) include dues paid to Chambers of Commerce. Dues paid to Army, Navy, and Air Force Associations are unallowable (7-1100). The minimum fee for membership in any university's industrial liaison program is allowable if reasonable, provided it is supported by evidence of bona fide services available or rendered (7-1100). Expenditures for influencing legislation are unallowable by Federal statute. Any identifiable portion of the costs of memberships in bona fide trade, business, technical, and professional organizations, intended for use in connection with influencing legislation is likewise unallowable (FAR 31.205-22).

l. Other Public Relations Costs to Promote Sales

(1) Under FAR 31.205-1(f)(8), unallowable public relations costs include all public relations costs, other than those specified in FAR 31.205-1(e) whose pri-

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mary purpose is to promote the sale of products or services by

(a) stimulating interest in a product or product line (except for those direct selling costs made allowable under FAR 31.205-38(c)), or

(b) disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services.

(2) Nothing in FAR 31.205-1(f)(8) modifies the express unallowability of costs listed in FAR 31.205-1(f)(1) through (7). The purpose of FAR 31.205-1(f)(8) is to provide criteria for determining whether costs not specifically identified should be unallowable.

7-1203 Public Relations Costs**7-1203.1 Contractor's Accounting Systems**

Public relations consists of different types of materials and services which by themselves may be separately treated in FAR 31.205. Moreover, many contractors do not establish public relations as a separate category of cost in their accounting systems. Although they may be recorded in other accounts, public relations costs are most likely to be found as part of:

- a. Advertising Costs (FAR 31.205-1).
- b. Compensation for Personal Services (FAR 31.205-6).
- c. Contributions and Donations (FAR 31.205-8).
- d. Employee Morale, Health, Welfare and Food Service and Dormitory Costs and Credits (FAR 31.205-13).
- e. Entertainment Costs (FAR 31.205-14).
- f. Labor Relations Costs (FAR 31.205-21).
- g. Other Business Expenses (FAR 31.205-28).
- h. Professional and Consultant Service Costs—Legal, Accounting, Engineering and Other (FAR 31.205-33).
- i. Selling Costs (FAR 31.205-38).
- j. Trade, Business, Technical and Professional Activity Costs (FAR 31.205-43).

7-1203.2 Review of Public Relations Costs

Contractor expenditures for public relations and advertising activities identified in FAR 31.205-1(f) (see 7-1202.2) and those which meet the criteria for contributions and donations, or entertainment costs are unallowable under the cited FAR provisions. The extent of and criteria for allowability of the other above listed cost categories are expressed in the identified FAR paragraphs. Appropriate audit steps should be designed to identify public relations items in each category and to evaluate their allowability.

a. Factors to be Considered

When reviewing the different categories of costs, the most important major factors to be considered are the nature of the service rendered, the function performed, the propriety of the base of allocation, and the basic consideration of reasonableness as defined in FAR 31.201-3. Nomenclature or similar less-than-in-depth reviews are apt to result in an incorrect determination.

(1) Nature of Services Rendered and Functions Performed

The nature of the service rendered and the function performed are important in determining the proper classification of costs. FAR 31.204(c) provides that the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with the cost at issue. This FAR provision prevents contractors from successfully claiming unallowable public relations costs under more favorable and broader cost principle coverage; e.g., unallowable costs of ceremonies (FAR 31.205-1(f)(4)) claimed as employee morale and welfare under FAR 31.205-13 (but see 7-1917.3).

(2) Reasonableness and Allocability of Costs

(a) The auditor should be primarily concerned with the positive criteria of allowability, reasonableness and allocability. Costs will generally be considered reasonable if they are of a type normally recognized as ordinary and necessary for the contractor's business, or are the actions of a prudent businessman in the

conduct of competitive business. On the other hand, costs which represent a significant deviation from established business practices, increasing contract costs, are likely to be unreasonable.

(b) The reasonableness of costs should also be viewed from the standpoint of magnitude. Careful scrutiny should be given to large amounts of public relations expenditures especially when there have been significant increases relative to the base from prior years. This is particularly true when most of the contractor's costs are allocated to government contracts. Accordingly, where amounts appear to be disproportionately large or otherwise out of line, the auditor should consider questioning costs as appropriate, even though they fall within allowable classifications.

b. Special Audit Considerations

Special audit considerations for certain other items of public relations cost are summarized below.

(1) Government Requested Public Relations and/or Advertising Activities

The types of public relations and advertising costs which are unallowable, and the limited ones that are allowable, are set forth in FAR 31.205-1. Even in instances where a contractor is satisfying a contract related suggestion or request by government contracting personnel, a public relation or advertising cost that is classified as unallowable by this section remains unallowable. However, FAR 31.205-1(d) provides the contracting officer with the latitude to request public relation or advertising effort when needed to meet contract requirements. To be allowable, the public relations and/or advertising activity must be specifically required by contract or modification. Unallowability would also extend to the costs of exhibits in which the contractor is invited to participate by any agency of the government, and at which the company or its products are publicized for the purpose of delivering a sales message.

(2) Public Relations Account

The auditor may occasionally find a contractor that maintains an account entitled public relations. Such accounts should not be questioned/disapproved on a nomenclature basis; rather an adequate analysis of their contents should be made since they may contain both allowable

and unallowable costs. FAR 31.201-6 incorporates Cost Accounting Standard (CAS) 405 which requires contractors to identify unallowable costs (see 8-405). The auditor should coordinate with the administrative contracting officer in obtaining necessary refinements in the contractor's accounting procedures to identify unallowable public relations costs.

c. Reporting

Public relations types of costs are particularly sensitive because of their controversial nature. Audit coverage should therefore be of commensurate scope and depth. Reasons given in audit reports for audit questioned or disapproved costs should be clear, precise, and complete.

7-1204 Publication Costs

Publication costs claimed by a contractor may include costs related to the preparation and printing of such items as plant newspapers and magazines, recruitment pamphlets, technical brochures, and contractor and product capability promotional items. While the amounts individually may not be significant, collectively on DoD procurements they amount to significant dollars.

7-1204.1 Audit Guidelines

a. Audits of claimed publications costs should be based on an appropriate examination of the contractor's policies and procedures (6-600), as well as on a selective review of individual publications. FAR specifically allows (within limitations) help wanted, scarce and scrap material advertising (31.205-1(d)); house publications (31.205-13), and corporate stockholders reports (31.205-28).

b. The allowability of the cost of any publication which is construed as public relations and/or advertising must be determined in accordance with FAR 31.205-1. Unfortunately, the contents of the publications do not always lend themselves to a ready determination as to the FAR category into which they fall. To assist in these determinations the following guidance sets forth five broad categories into which most publications may be grouped.

7-1204.2 Broad Categories Covering Publications

Examples of the types of publications to be included under each category and factors which indicate the appropriate section of FAR under which the allowability of the related costs should be determined are discussed below.

a. Employee Welfare and Industrial Relations

(1) The most common publications of this type are regularly issued newspapers or magazines. These publications generally provide information as to events of interest within the organization or of the employees' outside activities. Although there are frequently articles on company achievements, the intent here is to instill a feeling of accomplishment rather than to advertise. Other industrial relations publications incorporate information on available employee benefits, safety, and education. Distribution of the above types of publications is usually limited to immediate employees and/or their families. The related costs of the foregoing publications are considered allowable under FAR 31.205-13.

(2) Recruitment pamphlets which are used primarily to explain the available fringe benefits to prospective employees should be considered in conjunction with the review of help wanted advertisements and as such are allowable under FAR 31.205-1 subject to the limitations of FAR 31.205-34 (see 7-1904).

b. Professional and Technical Articles

(1) These publications are disseminated to a professional or technical type audience and generally take the form of dissertations on technical subjects that are related to the contractor's products or activities. This type of publication has generated much of DoD's interest in contractors' house publications. In most instances the costs of publishing such material can better be related to professional activity costs since they are the result of, or are copies of, papers delivered at professional meetings. Others are reprints of magazine articles of scientific interest.

(2) In evaluating individual publications of this nature, difficulty may be experienced in determining whether they

should be classified as capability advertising or as technical treatises. Some difficulties will normally arise where there are subtle, even though infrequent, references to the contractor. Where such references are the only questionable aspect of the publication, it would be extremely difficult to support a position that these references necessitate consideration of the publication as an advertisement. Therefore, to the extent that the publication costs incidental to technical presentations at meetings and conferences and reprinting such technical papers for use in contractors' house publications are reasonable and allocable, and can be construed as dissemination of technical information rather than advertising, such publications are considered allowable within the intent of FAR 31.205-43.

c. Selling, Marketing, and Advertising

In those instances where the material provides little or no technical assistance to the recipient and is distributed to all customers and/or potential customers, the cost should be treated as advertising (FAR 31.205-1) or selling costs (FAR 31.205-38). More specific guidance in determining the allowability of selling costs is in 7-1300. Advertising costs of this nature are unallowable (see 7-1202.2a).

d. Contractor and Product Capability Promotional Items

(1) These differ from normal selling, marketing, and advertising publications in that they stress the superior capabilities of the contractor's facilities and/or personnel in research and/or development of new products. They may also advertise achievements of the contractor, but generally do not supply detailed technical data. Advertising costs of this nature are unallowable under FAR 31.205-1(f) (see 7-1202.2a). Accordingly, such costs should not be accepted under cost-type contracts and should be questioned in advisory audit reports for price negotiation purposes.

(2) Certain publications can be clearly identified as capability advertising; however, in some cases publications that provide technical data necessary for equipment operation may include some descriptive data that could be construed

as capability advertising if taken out of context. The primary purpose of the publication and type of distribution, such as, operating manuals delivered with the equipment, would be the significant factor in determining allowability.

e. Public Relations

This category includes pictures, decals, and promotional material that emphasize the contractor's accomplishments in producing equipment or providing services. They do not contribute to the performance of the government contracts, even if they are related to items produced under such contracts, but merely serve to enhance the contractor's reputation. The costs of such items are unallowable (see 7-1202.2).

7-1205 Contractor Logos and Emblems

7-1205.1 Contracting Officers' Position

A common practice for a company is to identify its products using logos and emblems. Some contracting officers are concerned over the costs being incurred for contractors' logos and emblems being placed on government systems. These contracting officers are treating the direct and indirect costs for logos and emblems produced by means of a special mold or casting (not simple stick-on adhesive decals) as unallowable advertising costs under FAR 31.205-1.

7-1205.2 Audit Procedures

a. Applicable FAR Provisions

The contracting officers' position reflects an internal negotiating/contracting policy. This policy is enforceable to the extent that contracting officers obtain contractor concurrence and include a specific clause in contracts making such costs expressly unallowable or issue a notice of intent to disallow. Unless contracts contain such a clause, contractors need only to comply with FAR 31.205-1 and FAR 31.201-3, Reasonableness.

b. The use of the terminology logos and emblems may be misleading. Logo is an abbreviation for the word logotype, which actually means the standard ways in which to letter or set in type the company trade name, while emblem rep-

resents the mark of a nonprofit organization. However, "contractor logos and emblems" as used in government contracting represent the actual design and typesetting of all company marks. Company marks can be trademarks (companies who manufacture products) or service marks (companies who provide services to their customers). Regardless of the type of mark, the key factor is the purpose for which the marks are designed. Marks are initially designed to meet three main purposes, (1) to indicate the origin of the product or service provided, (2) to guarantee quality consistency (the mark tells the buyer that the product or service is the same as that provided previously), and (3) to serve as an advertisement (simple enough to catch attention, complete enough to tell a story, and persuasive enough to move the viewer to action). When a company initially designs a mark, each of these three purposes are relevant. Therefore, disallowance of these costs under FAR 31.205-1 is generally not practicable. However, the initial design of logos and emblems may be challenged as unreasonable if costs are determined to be excessive.

c. While the initial design of a company mark cannot generally be questioned under FAR 31.205-1, the redesign can be. When a company redesigns its mark, the public is usually already familiar enough with the original mark to know the origin of the product; thus, this purpose is usually not relevant to a redesign. In addition, redesigning the mark does not serve to guarantee quality consistency, since the original mark already told the prospective buyer that the product or service is the same as that previously provided. However, redesigning the mark does serve as an advertisement, since it is intended to catch the attention of those who were previously unaware of the company, tell a story (a new one or the rephrasing of an old one), and be persuasive enough to move a viewer to take a form of action that the old mark could not. Thus, the major purpose of redesigning a company mark will usually be advertising; if this is the case, then these costs are unallowable under FAR 31.205-1.

d. A company mark may be redesigned for other reasons, such as a corporate merger, reorganization, etc. The auditor must carefully consider the purpose of redesigning the company mark in determining the allowability of such costs. For example, if the redesign results from a reorganization, then FAR 31.205-27, Organization Costs, should be considered in evaluating the allowability of these costs. Furthermore, as was the case with the initial design, the redesign of logos and emblems may also be challenged as unreasonable if costs are determined to be excessive.

e. Audit Review

(1) Auditors should continue to evaluate proposed advertising costs, including

the redesign of logos and emblems, in accordance with the FAR. Excessive costs of logos and emblems, even those falling within allowable categories under the FAR provisions, should be questioned based on reasonableness.

(2) Comments may be included, as part of the applicable report exhibit note, on the effect of the contracting officer's position on proposed costs.

(3) FAOs should assure that the auditor's review of contract provisions (see 3-202) clearly identify special contract clauses disallowing the costs of logos and emblems. Audit programs for evaluation of direct and indirect costs should include steps to verify compliance with this and other contractual cost limitations.

7-1300 Section 13 — Selling Costs**7-1301 Introduction**

This section contains general audit guidance in determining the allowability, allocability, and reasonableness of selling costs under government contracts including:

- a. Selling costs as discussed in FAR 31.205-38,
- b. Selling costs under Foreign Military Sales contracts as discussed in DoD FAR Supplement (DFARS) 225.7303-2 and 225.7303-4, and
- c. Contingent fees as discussed in FAR 3.400.

7-1302 General Audit Considerations

Selling expenses are subject to the same basic audit procedures and tests for allocability and reasonableness as manufacturing and administrative expenses. However, there are certain factors for special consideration. Where a significant amount of selling expense is involved there should be adequate tests of the individual items and accounts classified under this expense category to enable the auditor to fully understand (1) the type and size of the contractor's sales organization, (2) the basis of employee compensation, (3) the nature of the selling and distribution activities involved, (4) their relationship to the contractor's different operations, products or product lines, and (5) their applicability to government and commercial business. A nomenclature review of account titles is not sufficient for this purpose.

7-1303 Proper Classification of Selling Expenses**7-1303.1 Nature of Selling Effort**

a. The nature of costs classified and charged as selling expense should be compatible with the provisions of FAR 31.205-38. The costs of such effort are considered allowable if reasonable in amount. Although the generic term "selling" encompasses all efforts to market a contractor's products, the acceptability of the costs of this effort are governed by

several subsections of FAR 31.205. Costs that fall into the following categories should be classified accordingly. These costs should be evaluated using the appropriate subsection of FAR 31.205:

- (1) Advertising costs (FAR 31.205-1). Also see 7-1200.
- (2) Corporate image enhancement and public relations costs (FAR 31.205-1). Also see 7-1200.
- (3) Bid and proposal/independent research and development costs (FAR 31.205-18). Also see 7-1500.
- (4) Entertainment costs (FAR 31.205-14).
- (5) Long-range market planning costs (FAR 31.205-12).

b. FAR 31.205-38(b) states that costs of activities which are correctly classified and disallowed under the above cost principles are not to be considered as allowable costs under FAR 31.205-38 or any other subsection of FAR 31.205.

7-1303.2 Illustrations of Improper Classification

The following illustrations represent the use of other FAR 31.205 subsections in reviewing a contractor's claimed selling costs for proper classification:

a. A contractor incurred engineering costs incident to adapting a system currently being produced for the government on one program for possible use on another major weapon system. The engineering effort was related to reducing the weight of the current system so it would be suitable for use on the other program. The effort performed included (1) development of a new cooling concept; (2) development of a new mechanical configuration and installation concept; (3) installation analysis of electrical power requirements; and (4) evaluation of reliability predictions and maintainability considerations. The contractor classified and claimed these costs as selling expense. Since the nature of the effort was "development," the costs should have been classified as independent research and development expenses and the criteria contained in FAR 31.205-18 applied. The effort of technical personnel can

7-1303.1a.

properly be classified as selling costs only when they are functioning in a marketing role. Selling does not include generating the technology which the contractor is trying to market. Due to the government's exposure to risk in this area, technical effort charged to selling expense should be closely monitored and reviewed for proper classification.

b. A contractor incurred costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines and other media that were designed to call favorable attention to the contractor and its activities. FAR 31.205-38(b) prohibits the contractor from claiming these costs as selling expenses, since FAR 31.205-1(f)(5) specifically disallows such costs as unallowable advertising or public relations costs.

7-1303.3 Audit Techniques to Identify Improperly Classified Selling Costs

The audit techniques and procedures necessary to determine whether a contractor has properly classified selling effort may include:

a. Floor checks and interviews of contractor personnel.

b. A review of documentary evidence establishing the purpose of the effort. This may include work order authorizations, expenditure authorizations, management reports, and board of directors' minutes.

c. An examination of correspondence with selling agents to ascertain the true nature of the activities and evidence of disputes over amounts of fees and commissions due.

d. Technical assistance which may be useful in determining the proper classification of selling effort.

7-1304 Allocability of Selling Costs**7-1304.1 General Allocability Considerations**

a. FAR 31.201-4 and 31.203 contain criteria regarding the allocability of costs to cost objectives. These sections also apply to the determination of the allocability of selling costs. Proper allocability is accomplished by (1) the direct charge or (2) apportionment to particular cost

objectives such as products, product lines or individual contracts, by means of a basis that will apportion the expenses in accordance with the benefits derived by the particular cost objectives, or the purposes for which the expenses were incurred. Also see 6-606 regarding allocability.

b. FAR 31.202(a) and 31.203(a) require, for costs incurred for the same purpose in like circumstances, consistency in the allocation of these costs as direct or indirect costs. Where a specific type or category of selling expense is allocated as a direct charge to government contracts or other cost objectives, care must be exercised to assure that all items or transactions in the same type or category applicable to other cost objectives are likewise allocated as a direct charge.

c. FAR 31.203(b) addresses selection of appropriate bases for allocation of indirect costs. The selection of an appropriate base for the apportionment of selling expenses as an indirect charge involves certain considerations different from those applicable to manufacturing expenses. Manufacturing expenses are usually apportioned without regard to the specific end item being manufactured or the customer to whom the item may ultimately be sold. These latter factors, however, are important considerations in apportioning selling expenses which may indicate that an over-all allocation of selling expenses on the basis of cost of sales or cost of goods manufactured may not be equitable. The auditor should perform a careful analysis of the time, effort, and expense incurred for selling activities in relation to the company's products, product lines or other objectives to determine the most suitable base for apportioning selling expenses.

d. When a contractor, with contracts subject to the Cost Accounting Standards, includes selling costs in its G&A pool, those costs are subject to the provisions of CAS 410.40(d) and 410.50(b)(1). CAS 410 does not provide guidelines on how foreign selling cost should be allocated, but instead takes a permissive position. These sections require that marketing costs, whose beneficial or causal relationship to business unit cost objectives can best be measured by a base

other than a cost input base representing the total activity of a period, be removed from the G&A expense pool and allocated on a representative base. If a total cost input or value-added base is used to distribute G&A expenses, selling costs would then become part of the G&A allocation base. See also 8-410.

7-1304.2 Special Considerations for Allocability of Selling Costs

a. Selling agents' fees and commissions will usually be charged direct to contracts since, in most cases, independent agents are used and paid for individual sales transactions. However, where an agent is paid a retainer, fees may be charged indirectly. Where fixed retainer fees are paid to agents representing the contractor in specific geographical areas, they should normally be allocated to all applicable sales in these areas.

b. A review of past activities of the sales agents or selling agencies as they relate to the contractor's products or services may be useful in identifying causal or beneficial relationships of the agents' or agencies' services to the final cost objectives. A review of any agreements between sales agents and the contractor may also prove useful in verifying allocability.

7-1305 Reasonableness of Selling Costs

Reasonableness involves consideration of (1) the nature and amount of these costs in light of the expenses which a prudent individual would incur in the conduct of competitive business, (2) the proportionate amounts expended by government and commercial business, (3) the trend and comparability of the company's current period costs in relation to prior periods, (4) the general level of such costs within the industry, and (5) the nature and extent of the sales effort in relation to the selling costs and to the contract value. The foregoing considerations may result in a determination that a particular item or category of selling expense is not reasonable either in total due to its nature or in part due to the excessiveness of the amount involved (see FAR 31.201-3). In determining rea-

sonableness, the following factors should receive special consideration:

a. Some companies engaged in defense production expend substantial amounts to establish and maintain large staffs of salesmen and engineers whose primary function is obtaining new or additional government business on a prime or sub-contract basis for existing company products and to seek out other products required by the government which the company can manufacture with its existing facilities. The submission of unsolicited bids and proposals and the preparation of brochures setting forth the company's capabilities and past accomplishments with respect to defense work usually represent an important aspect of this function. In periods of low volume, companies may divert normal production engineering personnel to augment their sales staff on a temporary basis or hire additional sales personnel to increase volume.

b. If appropriate safeguards are not maintained with respect to selling expenses, companies engaged wholly or substantially in government production under flexible price type contracts may conceivably be encouraged to increase their selling activities without restraint since they would expect to be compensated therefor as a necessary cost of doing business. Other companies in the same industry with little or no existing flexible price government business (cost-type or price-redeterminable contracts) would thus be placed in an unfavorable competitive position for new government business as compared with those companies who in effect have been subsidized by the government for their selling activities.

c. Each audit should also include an appraisal of the extent to which the sales promotion, consultation, technical, liaison and other related activities engaged in by the contractor's personnel produced a recognizable benefit to the government in consonance with the amounts included in the contractor's claims or cost representations. "Benefit to the government" should be considered, in a broad sense, as the acceptability of selling expense is not necessarily contingent upon a showing of proof that the performance of a specific item would not have been possible with-

out the incurrence of such expenses. If it can be established that useful and desirable information was exchanged or that technical matters concerning existing contracts were discussed during visits by the contractors' personnel to government procurement offices, the resulting costs may be considered to result in "benefit to the government." This situation is contrasted with visits made for purely promotional purposes where a contractor's sales representative seeks government contracts or related information and his or her visits do not result in any commensurate benefit to the government.

d. While DFARS 225.7303-4 is applicable to acquisitions made for the purpose of Foreign Military Sales (FMS), DFARS 225.7303-4(a)(3) contains criteria for determining the reasonableness of sales agents' fees or commissions that can be applied in evaluating the reasonableness of sales agents' fees and commissions on non-FMS contracts as well. This section states "The basic test of reasonableness is an assessment of the services provided, or to be provided, compared to the amount of the fee. In addition to the fee breakdown of services, a comparative analysis may be made of the proposed fee/commission with recent payment for comparable services under commercial sales (non-FMS) of the same or similar items, and sales commissions and fees allowed on previous FMS of comparable scope and dollar amounts. In analyzing the fee, consideration should be given to whether the sale is the initial or follow-on sale because the effort for follow-on sales of additional quantities, spares, and support equipment would not normally be as great as the effort for the initial sale."

7-1306 Allowability of Selling Costs

7-1306.1 Introduction

Several types of selling costs are expressly unallowable per FAR 31.205-38 and other subsections of the FAR and DFARS. FAR 31.201-6 and CAS 405 (see 8-405), require contractors to identify and exclude any expressly unallowable costs, including directly associated costs, from any billing, claim, or proposal applicable to a government contract. FAR

31.205-38(b) states that costs that have been made expressly unallowable by other subsections of FAR 31.205 shall not be allowable as selling costs under 31.205-38 (see 7-1303). Auditors should screen selling costs to ensure that contractors have properly identified and segregated the expressly unallowable costs discussed in the sections that follow.

7-1306.2 Foreign Selling Costs

a. Direct selling costs incurred in connection with potential and actual Foreign Military Sales, as defined by the Arms Export Control Act, or foreign sales of military products or services have been specifically allowable or unallowable on U.S. Government contracts for U.S. Government requirements depending on the date of the contract or when the costs were incurred and the issuing agency.

b. The following chronology shows the regulatory history of foreign selling costs (see 7-1202.2g): Prior to 3/12/79

Selling costs were allowable subject to a proportionate benefit being received by the U.S. Government. (DAR 15-205.37(b)) 3/12/79 - 1/20/86

Foreign selling costs were unallocable to U.S. Government contracts for its own requirements. The ASBCA held that this meant unallowable. (DAR 15-205.37(b), FAR 31.205-38(f)) 1/20/86 - 5/15/91

Foreign selling costs were unallowable on U.S. Government contracts for its own requirements. (FAR 31.205-38(f)) 4/12/88 - 12/15/88

Costs of "significant effort" to export American Aerospace products were made allowable in the FAR as an exception to the normal rule on foreign selling costs. (FAR 31.205-1(g)) Other foreign selling costs remained unallowable. (FAR 31.205-38(f)) 12/15/88 - 5/15/91

Costs of "significant effort" to export U.S. defense industry products were made allowable (as an exception to the FAR rule) for DoD contracts, subject to a ceiling of 110% of the prior year's costs for those contractors allocating \$2,500,000 or more of such costs to DoD contracts. (DFARS 231.205-1 & 231.205-38) The FAR rules were unchanged. 5/15/91 - Current

Costs of "significant effort" to export products normally sold to the U.S. Gov-

ernment are allowable for all U.S. Government contracts subject to a ceiling of 110% of the prior year's costs (for those contractors allocating \$2,500,000 or more of such costs to U.S. Government contracts) and the allocability, reasonableness, and allowability tests otherwise applicable to such costs. The previous specific foreign selling costs rules are removed from the FAR and the DFARS. (FAR 31.205-1(d) & 31.205-38(c)(2))

c. Contractors are responsible for identifying expressly unallowable costs as specified in 7-1306.1 and for analyzing the equity of any allocation processes utilized to assign costs to final cost objectives. Auditors should review the contractor's analysis to ensure that the government is not paying for a disproportionate share of selling costs.

d. Effective 15 December 1988, the DAR Council issued new DFARS cost principle coverage for foreign selling costs to implement the requirements of Section 826 of the Defense Authorization Act for FY 1989 (P.L. 100-456). DFARS 231.205-38 made allowable broadly targeted selling efforts, direct selling, and short-term planning efforts, incurred in connection with a significant effort to promote export sales of products of the U.S. defense industry. Note these efforts were originally allowable on DoD contracts only.

(1) DFARS 231.205-38 established a ceiling amount for allowable foreign selling costs with respect to a business segment that allocates to DoD contracts \$2.5 million or more of such costs in any fiscal year. The allowable ceiling amount is limited to 110 percent of foreign selling costs incurred by the business segment in the previous fiscal year. The reasonableness of costs for all other business segments is determined in terms of usual reasonableness criteria.

(2) DFARS 231.205-38 provisions were applicable to new contracts awarded on or after 15 December 1988 and to all other DoD contracts performed by the contractor on the first day of the contractor's first full fiscal year beginning on or after 15 December 1988. In other words, this rule applied to DoD contracts which predated the effective date of the rule.

This grandfather provision was to expire on 28 September 1991.

(3) Effective 5/15/91 the DFARS coverage was moved to the FAR applying the rule to all domestic U.S. Government contracts. The \$2.5 million criteria for a ceiling, the 110% computation, and the definition of the covered costs were applied to products normally sold to the U.S. Government instead of U.S. defense industry products. The grandfather clause was continued, but only for DoD contracts and without an expiration date.

(4) It should be noted that with the implementation of the Congressionally proscribed 110% ceiling, the regulations moved away from the proportionate benefit concept, that selling cost allocations cannot be made to U.S. Government contracts which would exceed the ratio that would have pertained if the domestic defense selling cost pool and base were net of foreign selling activities and foreign sales. The regulations drop limits associated with the proportionate benefit concept, and adopt only the limit imposed by Congress, the 110% ceiling.

7-1306.3 Sellers' or Agents'

Compensation, Fees, Commissions, etc.

a. FAR 31.205-38(g) makes unallowable sellers' or agents' compensation, fees, commissions, percentages, retainer, or brokerage fees, whether or not contingent upon the award of contracts, except when paid to bona fide employees or established commercial or selling agencies maintained by the contractor. DFARS 225.7303-4 extends this guidance to FMS contracts (see 7-1307). The following guidance is applicable to the review of sales agents' fees and commissions:

(1) Business firms sometimes hire an independent organization or individual to conduct business on their behalf. Often this is done for foreign locations where it would be too difficult and/or expensive to open and maintain a regular place of business. An organization or individual hired for this purpose is known as an "agent" of the employing firm. If hired specifically to make sales for the firm, the person or organization is known as a sales agent and is usually paid a fee or commission calculated on some percentage of his sales.

7-1306.3a.

(2) Agents' fees are normally not encountered in domestic DoD contracts. They are usually included in foreign military contracts and may be paid under either of two forms of foreign procurements: (a) the foreign government may buy direct from a U.S. contractor or (b) it may use DoD's procurement resources to buy items commonly referred to as foreign military sales (FMS). In either case, if agents are involved in arranging the sales, their fees should be identified in contractors' proposals. See 7-1307 regarding FMS contracts.

(3) FAR 3.402 states that contingent fees for soliciting or obtaining government contracts are considered contrary to public policy because such arrangements may lead to attempted or actual exercise of improper influence. However, an exception is provided for contingent compensation arrangements with bona fide employees or bona fide agencies (FAR 3.402(b) & FAR 31.205-38(g)). In the event that there is a reasonable basis to conclude that the employee or agency has held out as being able to obtain any government contract through improper influence, as defined in FAR 3.401, the employee or agency shall not be considered bona fide and any compensation, fees, etc. paid to such an employee or agency would be unallowable per FAR 31.205-38(g). FAR 3.408-2 provides evaluation criteria for determining whether an employee or agency is bona fide.

(4) Certain situations may require the contractor to file Standard Form 119, Contractor's Statement of Contingent or Other Fees (see FAR 3.404). This may be useful in identifying any unallowable fees or commissions.

b. Payments of commissions, fees, or compensation of any kind by, or on behalf of, a subcontractor to any officer, partner, employee, or agent of a prime contractor or upper-tier subcontractor as an inducement for, or acknowledgment of, a subcontract award under any negotiated contract with the government are prohibited by the Anti-Kickback Statute. When the auditor discovers that such fees or commissions have been paid, the procedures in 4-704 should be followed.

7-1307 Selling Costs Under Foreign Military Sales (FMS) Contracts

7-1307.1 General Requirements

The basic procurement policy for pricing FMS contracts is in DFARS 225.7303. These regulations supplement those policies contained in FAR Part 31 and FAR Subpart 3.4.

7-1307.2 Definition of Foreign Military Sales (FMS)

The Foreign Military Sales Act of 1968 defines FMS as sales of defense articles and services to foreign governments. Although it is DoD policy to encourage the purchase of defense articles and services directly from U.S. sources, most of them are purchased through established DoD procurement and contract administration channels because many kinds of defense transactions are not conducive to direct sales. These include transactions that require government-to-government arrangements, such as sales of classified equipment, items produced in U.S. arsenals, major weapon systems, and sales in situations where the U.S. government wants to exercise special control. Additionally, foreign governments usually want the advantages of DoD's procurement expertise, including contract administration and audit. Thus, FMS only encompasses government-to-government transactions as defined by the DoD Military Assistance and Sales Manual.

7-1307.3 Audit Considerations

a. DFARS 225.7301(b) requires that FMS contracts be priced on the same principles and with the same care used in pricing normal defense contracts. DFARS 225.7303 states that costs that are not allowable under FAR Part 31 are not allowable under FMS contracts. However, application of the cost principles contained in FAR Part 15 and FAR Part 31 may require pricing results that differ from normal defense contract prices for the same item. Therefore, DFARS 225.7301(d) requires known FMS requirements to be separately identified in solicitations.

b. DFARS 225.7303-2(a)(1) provides for the recognition of, under FMS con-

tracts, the costs of doing business with a foreign government or international organization.

c. According to DFARS 225.7303-2(c), the ceiling limitations or the formula constraints on bid and proposal (B&P) costs and on independent research and development (IR&D) costs incorporated in FAR Part 31.205-18 shall not be applicable to FMS contracts. IR&D and B&P costs allowed on FMS contracts shall be limited to their allocable share of the total expenditures. In pricing FMS contracts, the best estimate of reasonable costs shall be used in forward pricing. Actual costs, to the extent that they are reasonable, shall be used in determining final cost.

d. Costs of sales agents' commissions or fees under FMS contracts are subject to the allowability criteria as specified in FAR 31.205-38(g) (see 7-1306.3). However, DFARS 225.7303-4 provides additional guidelines on the allowability of sales commissions and contingent fees under FMS purchases. The following guidance is relevant when reviewing the acceptability of sales commissions and contingent fees under FMS contracts:

(1) As specified in FAR 31.205-38(g), the commissions and fees are allowable only if paid to a bona fide employee or a bona fide established commercial or selling agency. However, DFARS 225.7303-4 limits the allowable costs of sales commissions and contingent fees to \$50,000 per contract, including all modifications and subcontracts thereto. In addition, any such fees must be made known to the purchasing government (see DFARS 225.7303-4).

(2) The contractor must support and justify all sales commissions and contingent fees as specified in DFARS 225.7303-4(a). The auditor should evaluate the adequacy and accuracy of the information required by DFARS 225.7303-4(a), submitted to the contracting officer. Verify that the contractor has filed Standard Form 119, Statement of Contingent or Other Fees. Any other known documents or information bearing on the allowability and reasonableness of the agent's commissions or fees should also be requested from the contractor.

(3) DoD is seldom in a position to verify the services rendered by an agent or the value of those services. It is therefore DoD policy that anticipated sales commissions and contingent fees be made known to a country prior to or in conjunction with submission of the DoD Offer and Acceptance (DD Form 1513). The contractor's explanation of or justification for the proposed charge, together with any other data requested by the purchasing government, may also be included in the Offer and Acceptance. Acceptance of the offer by the purchasing government constitutes approval of the commission or fee. DoD will not accept any fee if disapproved by the foreign government. It is often not possible to determine if a proposed contract price will include sales commissions or fees prior to Offer and Acceptance. In such instances, DoD will notify the purchasing government as soon as possible if subsequent contract negotiations indicate that agents' fees will be claimed. Unless the purchasing government indicates within 30 days that it will not accept the charges, DoD will determine acceptance of the costs. Contractors must submit Standard Form 119, Statement of Contingent or Other Fees, along with a breakdown of the fee related to services performed by the sales representative to facilitate DoD's review. If the foreign government disapproves a fee, or a portion of it, the contracting officer will notify the prospective contractor and request withdrawal of the proposed charge.

(4) Additional guidance is provided in DFARS 225.7303-4(a)(3) concerning tests of reasonableness of the fees. Commissions and other items of cost such as taxes and miscellaneous fees, unique to each country, must be handled on an individual basis in evaluating the overall reasonableness of the agent's fees. These costs should be brought to the contracting officer's attention through coordination and reporting.

(5) Sales commissions and fees for follow-on spares provided under DoD Cooperative Logistics Supply Support Arrangements are unallowable per DFARS 225.7303-4(a).

(6) DFARS 225.7303-4(d) provides a listing of countries that have prohibited

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the payment of sales commissions or fees, unless such payments have been identified and approved in writing by the government involved prior to contract award.

7-1307.4 Foreign Military Sales (FMS) Offset Arrangements

a. There are three common arrangements for foreign military sales (FMS) offsets (see DFARS 225.7307): (1) a co-production approach where some of the contracted product is produced in a specified country, (2) an arrangement where a contractor must purchase a specified amount of a certain product line from a country, and (3) an arrangement where a contractor must establish a market in the United States for a country's product or service not related to the contractor's product lines, such as clothing, food, or tourism. These arrangements may be solely between the contractor and the foreign government or may also have some U.S. Government involvement.

b. Most contractors with offset arrangements absorb all additional costs related to the arrangement either as direct FMS contract costs or as a profit-and-loss item. On 15 July 1991 the Director of Defense

Procurement issued a memorandum indicating that effective immediately DFARS 225.7303-2(a)(2)(iii) had been revised to permit defense contractors to recover allowable offset administrative costs from foreign governments under FMS contracts provided the FMS Letter of Offer and Acceptance (LOA) includes (1) specific mention of offsets, (2) a statement that the contract price may include offset administrative costs, and (3) a notice that the U.S. Government assumes no obligation relative to the offset requirement or to bear any of the associated costs. In addition, offset administrative costs must be reasonable and readily identifiable. Examples of offset administrative costs are presented in DFARS 225.7303-2(a)(2)(iii)(C). Auditors should be sure that these additional costs are not charged to indirect expense pools and allocated to domestic business. Since these costs were incurred as a direct result of FMS contracts, they are allocable only to the benefiting FMS contracts. Costs incurred as a result of offset agreements are therefore not allocable to domestic government contracts and should be questioned if claimed by the contractor.

7-1400 Section 14 — Taxes**7-1401 Introduction**

This section provides general guidance in reviewing the allocability and allowability of taxes, including Federal, state, and local taxes; employment taxes; employment taxes of successor contractors following mergers or consolidations; and Federal excise taxes.

7-1402 Expressly Unallowable Taxes

FAR 31.205-41(b) states that the following types of taxes are expressly unallowable as costs under government contracts:

a. Federal income and excess profits taxes.

b. Taxes in connection with financing, refinancing, or refunding of operations, or reorganizations (See also FAR 31.205-20 and 31.205-27).

c. Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the government, except when the contracting officer determines that the administrative burden of obtaining the exemption outweighs the benefits accruing to the government (See FAR Part 29).

d. Special assessments on land that represent capital improvements.

e. Taxes (including excises) on real or personal property, or on the value, use, possession or sale thereof, which is used solely in connection with work other than on government contracts (See also 7-1403.1a below).

f. Taxes on accumulated funding deficiencies of, or prohibited transactions involving, employee deferred compensation plans pursuant to Section 4971 or Section 4975 of the Internal Revenue Code of 1986, as amended.

g. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements (See also 7-1403.3a below).

7-1403 State and Local Taxes

State and local taxes, including property taxes, franchise, and income taxes, are allowable contract costs in accordance with FAR 31.205-41.

7-1403.1 General Audit Considerations

a. Care must be exercised regarding the propriety of allocation of certain taxes to government work. For example, the allocation to all work of the contractor of personal property taxes levied against the contractor's commercial inventories may not be proper where similar taxes are not levied against government contract inventories.

b. FAR 31.205-41(b)(5) states that taxes (including excises) on real or personal property, or on the value, use, possession, or sale thereof, which is used solely in connection with work other than on government contracts are not allowable. FAR 31.205-41(c) states that these taxes should be allocated to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained. The costs of taxes incurred on property used in both government and non-government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

c. Where a contractor's cost representation includes the cost of taxes paid which are otherwise allowable, but in connection with which a question of illegality or erroneous assessment exists, the amounts should be identified and described in advisory audit reports and contract audit closing statements so that, if it is subsequently determined that the taxes have been improperly assessed, a credit or refund may be pursued by the government (See FAR 31.205-41(a)(2)).

(1) The auditor should follow up as appropriate to assure that a proper share of credits or refunds received by the contractor is passed on to the government (See FAR 31.205-41(d)).

(2) If the contractor has failed to take actions as specified in FAR 31.205-

7-1403.1c.

41(a)(2), the costs should be questioned or disapproved.

7-1403.2 Allocation Problems and Methods

a. State income or franchise taxes sometimes present unique allocation problems. From a taxing standpoint, when a corporation is engaged in activities in several states it becomes necessary to determine the share of a corporation's income to be attributed to each state. The states have developed three primary methods of dividing the income of a multi-state taxpayer: separate accounting, specific allocation, and formula apportionment. Each method is discussed below.

(1) **Separate Accounting.** The separate accounting method is based on the premise that a multi-state taxpayer can be divided into separate entities so that its activities within the taxing state can be segregated from its activities elsewhere and accounted for separately. This method is seldom acceptable to the states.

(2) **Specific Allocation.** The specific allocation method provides for the designation of specified items of income in their entirety as either within or outside the state. This method is infrequently used by itself, but is often combined with the formula apportionment method discussed below.

(3) **Formula Apportionment.** This is the most frequently used method. The percentage of income to be assigned to a particular state is determined by averaging a number of ratios. For example, one ratio frequently used is the ratio of in-state sales to out-of-state sales. Similar ratios are commonly based on property and on payroll. The average of the ratios used is then multiplied by the net income subject to apportionment (defined by the state) to arrive at the taxable income for the state.

b. Through the use of the method described in a.(3) above, it is possible that a multi-state taxpayer may be assessed a large corporate state income or franchise tax by a particular state and in actuality have very little income recorded on the books of its operations within that state. Apportionment of unitary income in excess of local book income within the

state is justified by courts on the assumption that all component activities, wherever located, contribute proportionately to all corporate income.

c. Contractors often include the above discussed taxes, along with other indirect expenses, in an established burden center for allocation to operating divisions located in various states. In reviewing these allocations, the general rule for the auditor to follow is to determine that the amount allocated to operations within a particular state approximates the amount of tax paid to such state. The further allocation of this amount to cost centers or contracts within the state should be made through divisional G&A. However, in those cases where a division is doing business in several states, the auditor may find that more equitable results are obtained by applying the method used by the state in assessing the tax, or through an established burden center of the contractor other than G&A. The following guidance relates to the allocation of state franchise taxes to a company's segments:

(1) CAS 403.40(b)(4) requires that central payments or accruals (which may include state and local income taxes and franchise taxes) made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Any such types of payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which the total payment is based. (Also see 8-403.)

(2) Lockheed Corp. and Lockheed Missiles & Space Co., ASBCA Case No. 27921, 86-1 BCA para. 18,614, aff'd, 817 F.2d 1565 (Fed. Cir. 1987) and U.S. Court of Appeals for the Federal Circuit Case No. 86-1177 contain extensive and detailed discussions of the allocation of state franchise taxes to segments. In the ASBCA case, the Board ruled that Interpretation No. 1 to CAS 403 is not binding as to the meaning of CAS 403 because the promulgation of the Interpretation did not follow the statutory requirements for issuance of a standard and that a segment's income (or loss) was an appro-

appropriate factor to consider in the allocation of state franchise taxes to segments. The ASBCA decision was upheld by the Court. However, in rendering its decision, the Court's rationale departed somewhat from that of the ASBCA. It did not believe the validity of Interpretation No. 1 was relevant to its decision. The decision effectively relegated Interpretation No. 1 to the status of elaborating upon the CAS 403.60(b) illustration concerning taxes. The Court ruled that the one example in CAS 403.40(b) did not defeat the plain meaning of "factors" as used at CAS 403.40(b)(4). Since segment net income is a causal factor, the Court ruled that CAS 403.40(b)(4) permitted it in an allocation formula.

(3) The Court's ruling does not mean that all allocation methods that use segment book income are automatically compliant. The Court only held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4). In the ASBCA case that was the subject of the appeal, two other allocation methods that used income as an allocation factor were considered and rejected. The Lockheed method which the Court ruled is compliant and the two methods using income (the Factor Analysis, and Proration Percentage) that the ASBCA held were non-compliant are described and illustrated at 7-1403.3.

d. Allowing income as an allocation factor broadens the choices of possible allocation methods and makes the evaluation of tax allocations more difficult. Each situation must be carefully evaluated to determine if the particular methodology makes appropriate use of segment book income. The following two key areas deserve special attention when

evaluating any methodology which uses segment book income:

(1) The first is evaluating the contractor's methodology for determining the propriety of segment book income. For tax purposes, most states do not use segment book income as a unitary income apportionment factor because of concerns that companies could easily manipulate segments' books to show income only at segments that are in low-tax or no-tax jurisdictions. This risk of income manipulation is why most states choose not to accept the taxpayer's identification of segment income. Because proper identification of income is a high-risk area, we should carefully assess a contractor's determination of segment book income to ensure the methodology is sound and consistently applied.

(2) The second is ensuring that taxes are confined to segments doing business in the taxing jurisdiction. This issue was dealt with in the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992). The Court ruled that a contractor is not in full compliance with CAS 403 if the taxes of a jurisdiction are not allocated to only those segments that do business in the taxing jurisdiction.

7-1403.3 Illustrations of Allocation Methods That Use Income as an Allocation Factor

The illustrations below supplement the guidance in 7-1403.2 and are intended to be used as a guide when evaluating allocation methods that use segment book income. The following facts will be used for all three illustrations:

a. A company has a California Franchise Tax expense of \$11,000,000 and five segments — A, B, C, D, and E with property, payroll, and sales of:

	SEGMENTS					
	A	B	C	D	E	TOTAL
	(in millions)					
<u>PROPERTY:</u>						
Total	\$1,500	\$ 800	\$ 600	\$ 400	\$ 200	\$3,500
Calif.	750	720	600	100	20	2,190
Calif. %	50%	90%	100%	25%	10%	62.6%
<u>PAYROLL:</u>						
Total	\$ 700	\$ 300	\$ 250	\$ 100	\$ 80	\$1,430
Calif.	280	240	250	30	8	808
Calif. %	40%	80%	100%	30%	10%	56.5%
<u>SALES:</u>						
Total	\$2,000	\$1,000	\$ 800	\$ 600	\$ 300	\$4,700
Calif.	600	800	760	240	45	2,445
Calif.%	30%	80%	95%	40%	15%	52%
AVG CALIF. %	40%	83.3%	98.3%	31.7%	11.7%	57%

The five segments had the following net income (loss):

	(in millions)
Segment A	\$(200)
Segment B	125
Segment C	180
Segment D	90
Segment E	20
Total Net Income	<u>\$ 215</u>

b. Lockheed Two-Step, Four-Factor Method: The ASBCA and the Federal Circuit Court held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4). The first step entails

calculating each segment's net income derived from or attributable to a particular state's sources (e.g., California sources) using the ratio of in-state property, payroll, and sales, to total property, payroll, and sales for the segment. In the second step, Lockheed totals individual segment net income derived from or attributable to profitable in-state sources and then assigns taxes only to each profitable segment in the proportion that the segment's profits bear to total profits. Segments with no net income get no allocation and segments that do get allocations get them based upon relative profitability.

STEP 1:

	(in millions)				
	Segment net income (loss)		Segment apportionment %		Segment net income from Calif. sources
Segment A	\$(200)	×	40%	=	\$ 0*
Segment B	125		83.3%		104
Segment C	180		98.3%		177
Segment D	90		31.7%		29
Segment E	20		11.7%		2
					<u>\$ 312</u>

* Note: Credits are not permitted, therefore segments with losses always are assigned \$0 income.

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STEP 2:

		(in millions)			
	<u>Total tax</u>		<u>Segment contribution</u>		<u>Allocation</u>
Segment A	\$ 11	×	0	=	\$ 0
Segment B	11		104/312		3.67
Segment C	11		177/312		6.24
Segment D	11		29/312		1.02
Segment E	11		2/312		.07
					<u>\$11.00</u>

c. Factor Analysis Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA considered and rejected an allocation method that used income entitled the "Factor Analysis Method." Under this method a segment's share of total California Franchise Tax liability is calculated by first determining the percentage that the segment's net income is of the total net income (segment net losses result in negative percentage). A second percentage is calculated by averaging the ratio of the segment's California property, payroll,

and sales to the total California property, payroll, and sales. Next the two percentages are averaged by adding them together and dividing by two. The resulting percentage is then multiplied by the total California Franchise Tax expense to obtain the amount of tax or credit allocated to the segment.

The ASBCA concluded that the Factor Analysis Method did not comply with CAS 403 because it allows credits for loss segments. Including credits for losses yielded allocations in excess of the actual amount actually paid. Following is an illustration of this method:

STEP 1:

	(in millions)			
<u>Segment net income as % of total income (loss)</u>	<u>Segment Calif. property, payroll, and sales as % of total Calif. property, payroll, and sales</u>			
	<u>Property</u>	<u>Payroll</u>	<u>Sales</u>	
A (200)/215 or (93%)	$750/2190 = 34\% + 280/808 = 35\% + 600/2445 = 25\%$			or 31%
	3			
B 125/215 or 58%	$720/2190=33\% + 240/808=30\% + 800/2445=33\%$			or 32%
	3			
C 180/215 or 84%	$600/2190 = 27\% + 250/808 = 31\% + 760/2445 = 31\%$			or 30%
	3			
D 90/215 or 42%	$100/2190 = 5\% + 30/808 = 4\% + 240/2445 = 10\%$			or 6%
	3			
E 20/215 or 9%	$20/2190 = 1\% + 8/808 = 1\% + 45/2445 = 2\%$			or 1%
	3			

STEP 2:

	Sum of two % divided by 2		Total tax	Allocation (Credit)
Segment A	$[(93\%) + 31\%]/2 = (31\%)$	\times	\$ 11 =	\$ (3.41)
Segment B	$[58\% + 32\%]/2 = 45\%$		11	4.95
Segment C	$[84\% + 30\%]/2 = 57\%$		11	6.27
Segment D	$[42\% + 6\%]/2 = 24\%$		11	2.64
Segment E	$[9\% + 1\%]/2 = 5\%$		11	.55
				<u>\$ 11.00</u>

Note: Together, segments B, C, D, and E are allocated \$3,410,000 more in tax expense than the total California Franchise Tax liability.

d. Proration Percentage Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA also considered and rejected a second allocation method that used income. This one was called the Proration Percentage Method. Under this method a segment's share of the state tax liability is calculated by multiplying the segment's net income or net loss by the ratio of in-state property, payroll, and sales, to total property, payroll, and sales. The product

is then multiplied by the state tax rate to yield the amount of tax or credit allocated to the segment.

The ASBCA rejected the Proration Percentage Method because it in effect allocates only on the basis of profit and loss. In other words, there is no consideration of each segment's apportionment factors. Moreover, this method also included credits for losses and would result in allocations to profitable segments in excess of actual taxes paid. Following is an illustration of this method:

	Segment net income (loss)	(in millions)	Calif. Apportionment %	Calif. Franchise Tax rate	Allocation (credit)
Segment A	\$ (200)	\times	57%	\times	9% = \$(10.2)
Segment B	[125		57%		9% 6.4
Segment C	[180		57%		9% 9.2
Segment D	[90		57%		9% 4.6
Segment E	[20		57%		9% 1.0
					<u>\$ 11.0</u>

7-1403.4 Guidance in Determining Allowable State and Local Taxes

a. Tax Accruals

(1) Provisions are sometimes made by contractors to account for estimated state income or franchise taxes when there are significant differences between taxable income, as determined in accordance with state regulations, and income for the period, as determined in accordance with generally accepted government accounting principles. These differences may

result from items such as (a) recognizing in the income statement possible losses that may not be deductible for tax purposes until they occur, (b) computing depreciation for income statement purposes by use of a method different from that used for tax purposes, or (c) by recognizing revenue for tax purposes before it would be recognized in the income statement in accordance with generally accepted government accounting principles. Provisions are made for taxes relat-

ed to such items based on an assumption that a tax liability exists, and will ultimately materialize, as a direct result of such transactions. For example, in the case of a straight line method of depreciation being used for income statement purposes and an accelerated method for tax purposes, the tax savings in the early years of the asset's life will ultimately be offset by higher taxes in the later years of the asset's life. Therefore, the provisioning of an additional amount for taxes in the early years of the asset's life to offset the higher taxes in the later years in effect tends to relate the state income tax expense for the period to the income as shown in the financial statements. The opposing view contends that if a contractor follows a consistent program of asset replacement, which would be necessary to a continuing concern, tax savings on new assets should offset higher taxes on expiring assets.

(2) The auditor is concerned with the best evidence available which supports the amount of costs incurred. In determining allowable costs under government contracts, the best evidence available to support the amount of state income or franchise tax incurred is the amount paid. The auditor should not attempt to estimate the amount of tax currently being paid, but applicable to future or prior periods, for purposes of determining allowable costs under government contracts. Similarly, amounts estimated by contractors as tax liabilities in excess of the amounts actually paid should not be considered in determining allowable contract costs. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements are unallowable (See FAR 31.205-41(b)(7)).

(3) Income tax accruals designed to estimate additional taxes to be paid resulting from tax audits by the state or local tax authorities are considered contingencies that are unallowable within the purview of FAR 31.205-7(b). However, tax accruals designed to relate the amount paid on the basis of a taxing authority's fiscal year to the contractor's accounting period are allowable in accor-

dance with FAR 31.205-41(a). (See also 7-1402.g.)

b. Tax Credits and Refunds

(1) Many states follow the same or basically similar procedures as provided in the Internal Revenue Code for net operating loss carry-backs. In most states a net operating loss can be carried back for 3 years or forward for 5 years. We are primarily concerned with carry-backs for state income or franchise taxes. Operating loss carry-backs will result in a refund of prior years' taxes which have been paid by the contractor and reimbursed by the government.

(2) The government's right to share in these refunds is covered by FAR 31.205-41(d), which provides that "Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the government in the manner it directs." This requirement is also addressed in FAR 31.201-5 and the "Allowable Cost and Payment" clause at FAR 52.216-7. Where the amount is material, equity dictates that the tax refund be allocated to the government customers in the same ratio as they were originally charged with the tax payment.

7-1403.5 Changes in Method of Measuring Taxable Income

a. State tax regulations have usually permitted a taxpayer to initially select one of several acceptable methods of stating the elements that determine taxable income and later, under specified conditions, to change from the initial selection to another acceptable method. Some elements for which alternate acceptable methods have been allowed are (1) income from long-term contracts, (2) inventory pricing, and (3) depreciation methods.

b. The Tax Reform Act of 1986 (TRA) repealed the acceptability of the completed contract method for measuring annual taxable income for long term contracts awarded after 26 February 1986. Since the TRA, the IRS has implemented additional restrictions on methods that can be used to measure annual taxable income. Although the changes in method are intended primarily to apply to Federal income taxes which are not

allowable on government contracts under FAR 31.205-41(b)(1), State income taxes, which are allowable on government contracts, will in many cases also be affected since a number of States have adopted Federal tax regulations to determine State taxes.

c. Under the provisions of the change, contractors must recognize income from long term contracts using either the percentage of completion method or the percentage of completion-capitalized cost method. Both methods must be based on a cost-to-cost relationship rather than an estimate of physical completion (engineering cost method or other modified methods not based on cost) which was previously permitted. The percentage of completion method based on a cost-to-cost relationship recognizes income from long term contracts based on the proportion of the estimated contract price that costs incurred through a period bears to the total expected costs reduced by the amounts of contract price that were included in income in previous years. Under the percentage of completion-capitalized cost method, only a certain percent of the items of each contract need to be recognized under the percentage of completion method and the remaining percent of the items are to be accounted for under the taxpayer's normal method (e.g., the completed contract method). Costs to be used in determining the percentage of completion are: (1) direct material and direct labor costs, and (2) depreciation, amortization and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the contract. It should be noted that the prescribed cost-to-cost relationship is an example of circumstances where the tax law is at variance with appropriate cost accounting.

d. Any changes made in the method of measuring income for long term contracts as a result of changes in tax regulations (e.g., a change from the completed contract method to the percentage of completion method or the percentage of completion-capitalized method) should be considered to be a change in cost accounting practice because it alters the measurement of State tax costs for a cost

accounting period by assigning taxable income or loss to other periods. Because measurement and assignment of cost are involved, the change in determining contract income is a change in cost accounting practice as described in CAS. Since the change is not being required by any change in CASB rules, regulations and standards, it should be considered to be a voluntary change. (See CAS Working Group Paper 81-25.)

e. Voluntary changes under CAS may be either discretionary or sanctioned changes. Since a contractor is being required to change by the tax laws, a change from a no longer acceptable method to an acceptable method would most likely be considered to be a sanctioned change. However, a final determination on this matter is the responsibility of the ACO. Unless the ACO makes the determination that the change meets the requirement to be considered a sanctioned change (that is, it is desirable and not detrimental to the interests of the government), the change would be considered a discretionary change covered by paragraph (a)(4)(iii) of the CAS clause (FAR 52.230-2) and no increased costs as a result of the change would be permitted (see also 8-303).

f. Auditors should also be aware that the TRA includes a look-back provision. This provides that, to the extent that the percentage of completion applies to a long term contract, a taxpayer who does not accurately predict the eventual contract price must recompute its tax liability for the years that such method was used on the basis of the actual contract price and costs. If the recomputed tax liability exceeds the previously reported tax liability, the taxpayer must pay interest; if the recomputed tax liability is less, the taxpayer is entitled to interest. This provision may affect State tax costs to the extent that this look-back provision is incorporated into State laws. Accordingly, auditors should review the look-back computations to determine if any unlawful penalties and interest are included in costs charged to government contracts or if the government is due a credit.

7-1404 Employment Taxes

a. The Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) each impose a tax upon employers for each calendar year, the amount of which is based upon a specified percent of the wages paid by the employer to his individual employees. The taxes are limited to the annual maximum wages established by statute for each individual employee. These rates and wage limits vary periodically. The taxes imposed by the FUTA are levied and collectible in part by the state and in part by the Federal government. The guidance in this paragraph is concerned with the phase of these taxes levied on employers and not on employees.

b. Generally, if during a calendar year an employee receives remuneration from more than one employer, the annual wage limitation does not apply to the aggregate remuneration received from all employers, but instead applies to each individual employer. Exceptions to this rule are discussed below in 7-1405 and 7-1406.

c. The auditor should familiarize himself or herself with the rates and wage limitations in effect for each calendar year and ascertain that the contractor is not paying taxes in excess of the statutory requirements. He or she should also obtain supporting documentation for the various state unemployment rates being used by the contractor in those states in which it is paying the tax. Attention should also be given to tax credits or reductions granted the employer in state unemployment tax rates because of favorable employment experience. In such cases, the auditor should accept as allowable costs only the actual (net) amounts which the contractor is required to pay.

d. Where historical data are the basis for cost projections or estimates, consideration should be given to the effect that prospective changes in the tax rates and annual wage limitations will have on such forecasts. The auditor should assure that where expense accruals are made for these taxes they are adjusted periodically so that costs charged to contracts do not exceed the actual cost.

7-1405 Employment Taxes of Successor Contractors

a. Successor contractor situations generally relate to yearly service or maintenance contracts at government installations where, under recompetition, a new contractor receives a cost-reimbursement type contract award, usually cost-reimbursement type, and takes over performance as of the beginning of the fiscal year, 1 July, and retains many of the same employees. In this regard, Revenue Ruling 68-105 (C.B. 1968-1, 418) holds that a new contractor may qualify as a successor contractor, where the property used in the performance of the contracts is the same government-owned property. It is immaterial that no interest in the property used was acquired directly from the predecessor employer.

b. Section 3121(a)(1) of the Federal Insurance Contributions Act (FICA) and 3306(b)(1) of the Federal Unemployment Tax Act (FUTA), respectively, and the applicable regulations provide that the wages paid by a predecessor to an employee shall, for purposes of the annual wage limitation, be treated as having been paid to the employee by a successor, if (1) the successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor; (2) the employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in his or her trade or business immediately after the acquisition; and (3) the wages were paid during the calendar year in which the acquisition occurred and prior to the acquisition. The method of acquisition by an employer of the property of another employer is immaterial. The acquisition may occur as the result of purchase or any other transaction where substantially all the property is acquired by the new employer.

c. If the new employer (contractor) meets these criteria, he or she may qualify as a successor employing unit so that for the purpose of establishing the wage limitations, remuneration paid to continuing employees by the predecessor during

the calendar year and prior to the acquisition shall be considered as having been paid by the successor. The statutory minimums then apply to the combined earnings under both contractors. Additionally, the successor may be eligible to file with state authorities and obtain a lower merit unemployment tax rate based on the predecessor's experience at the location.

d. Where a contract changes hands under the foregoing circumstances, or the auditor has knowledge that such a change is to occur shortly, it is a matter of some urgency that the auditor takes the following steps on a timely basis.

(1) Ascertain whether the new contractor has determined that it qualified as a successor. If there is any doubt or question as to its status, the contractor should obtain a ruling from IRS.

(2) Determine that the successor obtains the predecessor's earnings record and tax payments records for the current year on the continuing employees.

(3) Determine that the successor, if qualified, ceases from incurring further costs for FICA and FUTA as soon as an employee's total combined earnings under both the predecessor and successor reach the statutory wage limitations.

(4) Where a lower merit rating is available under FUTA, based on the predecessor's experience at the location, determine that the successor has filed with state authorities and has obtained and is using the more favorable unemployment tax rate. However, there are some states which do not recognize predecessor experience as being eligible in obtaining a lower merit tax rate.

(5) In the event that taxes have been paid in excess of the proper amounts, determine that the successor obtains refunds and properly credits the government.

(6) Advise the contracting officer of any failure of the successor to take full advantage of its status as a successor employing unit under both FICA and FUTA.

7-1406 Employment Taxes in Mergers and Consolidations

a. The Internal Revenue Service has ruled (Revenue Ruling 62-60, C.B. 1962-

1, 186) that, in the absorption of one corporation by another in a statutory merger or consolidation, the resultant entity is regarded as the same taxpayer and same employer as the absorbed corporation for FICA and FUTA purposes. Thus, there is no interruption in the employment status of the continuing employees and they are considered to have been in one employment throughout the year.

b. Where contractors have undergone statutory mergers or consolidation, the auditor should determine that FICA and FUTA taxes on the continuing employees are paid on the basis of a single employment for the year. Additionally, the auditor should ascertain whether credits for contributions to state unemployment funds and merit rating credits available to the absorbed corporation have been utilized by the surviving corporation.

7-1407 Federal Excise Taxes

Such taxes are allowable unless exemptions are available to the contractor (FAR 31.205-41(b)(3)). When there are substantial amounts involved (in either incurred or projected costs) and where there is a reasonable probability that the benefits of an exemption will outweigh the administrative burdens involved, the auditor should investigate the possibility that an exemption exists. If an exemption does not exist, appropriate inquiry or recommendation should be made to the contracting officer regarding the desirability of obtaining one.

7-1408 Foreign Income Taxes

a. When a contractor performs government contracts in foreign countries, whether under a Foreign Military Sales (FMS) contract or for domestic requirements, certain host countries impose income taxes on the contractor. FAR 31.205-41(a)(1) specifically addresses the allowability of Federal, state, and local taxes without addressing the allowability of foreign income taxes. Foreign taxes are analogous to state or local taxes however, and are therefore considered to be allowable contract costs.

b. When a contractor has paid an income tax to a host country, it can subsequently claim a foreign tax credit against its Federal income tax under Internal Revenue Code Section 901. If a contractor claim for a foreign tax credit is accepted by the Internal Revenue Service, it will result in a reduction in Federal income tax liability by the full amount of the credit. In that situation, the contractor would be duplicating the recovery of foreign income tax expenditures—first as a contract cost and second as a reduction in its Federal income tax liability.

c. This situation is addressed in contract clauses at FAR 52.229-6, 52.229-8, and 52.229-9 as well as in FAR 31.205-41(d).

(1) For fixed-price contracts, FAR 52.229-6(h) requires that if a contractor obtains a reduction in its U.S. tax liability because of the payment of any tax or duty which was included in the contract price, the amount of the reduction shall be paid or credited to the U.S. Government as directed by the contracting officer.

(2) For cost-reimbursable contracts awarded on or after 7 March 1990, FAR 31.205-41(d), 52.229-8 and 52.229-9 require that contractors and subcontractors pay or credit to the U.S. Government the amount of such reductions as directed by the contracting office unless the contract costs are being reimbursed by a foreign government. In the case of a foreign government reimbursing the contract costs, the contractor or subcontractor must repay the U.S. Treasury for any reduction in U.S. tax liability. FAR 52.229-9 specifically requires the pay-

ment to the Treasury and prohibits credit to a contract in such a case.

(3) For cost-reimbursable contracts awarded prior to 7 March 1990, FAR 31.201-5, "Credits," should be cited to assert the government's right to recover such reductions in U.S. tax liability.

d. Refer to 7-1921 for guidance on the evaluation of employee foreign tax differential allowances.

7-1409 Environmental Tax

a. The Superfund Amendments and Reauthorization Act of 1986, Public Law 99-499, designated funding sources for the Hazardous Substance Response Trust Fund ("Superfund"). Among the sources is the Environmental ("Superfund") Tax enacted by Section 516 and codified at Section 59A of the Internal Revenue Code. The tax is placed in the subtitle devoted to income tax provisions. The positioning of the statute in this subtitle and the direct relationship of the tax rate to income denotes this as a tax on income. The tax is equal to 0.12 percent of that portion of the corporation's modified alternative minimum taxable income which exceeds \$2,000,000.

b. For contracts awarded prior to 22 January 1991, the Superfund Tax is considered to be an expressly unallowable Federal income tax in accordance with FAR 31.205-41(b)(1). (The Director, Defense Procurement (OUSD(A)(DP)) agreed with this policy in a memorandum to DCAA dated 3 February 1992.) Effective 22 January 1991, FAR 31.205-41(a) was revised to make the Superfund Tax a specifically allowable cost for contracts entered into on or after that date.

7-1500 Section 15 — Independent Research and Development and Bid and Proposal Costs

7-1501 Introduction

a. A contractor's independent research and development effort (IR&D) is that technical effort that is not sponsored by, or required in performance of, a contract or grant and that consists of projects falling within the following four areas: (1) basic research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. Bid and proposal (B&P) costs are the expenses incurred in preparing, submitting, and supporting bids and proposals on potential government and non-government contracts. Coverage for both IR&D and B&P is contained in FAR 31.205-18 and in the DoD FAR Supplement 231.205-18.

b. All contractors (whether CAS covered or not) are subject to some or all of the provisions of CAS 420 (FAR 31.205-18(b)).

c. There was a fundamental change in the allowability criteria for IR&D and B&P for Contractor Fiscal Years (CFY) beginning after 30 September 1992. The allowability of costs incurred by contractors during CFYs beginning before 1 October 1992 is discussed in 7-1505. The allowability of costs incurred in CFYs beginning after 30 September 1992 is discussed in 7-1506. Special considerations for NASA contracts are discussed in 7-1507.

7-1502 Deferred IR&D and B&P

Deferred IR&D and B&P costs that were incurred in previous accounting periods are unallowable except when contract provisions specifically allow such costs. Refer to FAR 31.205-18(d) for details.

7-1503 General Considerations

a. For contracts awarded prior to 19 August 1991, allowable IR&D and B&P costs for DoD contracts, which were included in an advance agreement, should only be for projects that have a

potential relationship to a military function or operation (DFARS 231.205-18(c)(1) (vii)). Effective 19 August 1991, this provision was revised to expand eligible projects to include those that have "potential interest to DoD." DFARS 231.205-18(c)(2) provides five broad categories of IR&D and B&P projects that are specifically defined to be of potential interest to DoD. These five broad categories include activities that:

(1) Strengthen the U.S. defense industrial and technology base;

(2) Enhance the U.S. industrial competitiveness;

(3) Promote the development of technologies identified in the defense critical technologies plan that the Secretaries of Defense and Energy annually submit to Congress;

(4) Increase the development of technologies useful for both the private commercial sector and the public sector; or,

(5) Develop efficient and effective technologies for achieving environmental benefits.

b. DAC 91-4 (effective with the first CFY beginning after 9/30/92) added two more broad categories of projects that are of "potential interest" to DoD in that they:

(1) Enable superior performance of future U.S. weapon systems and components.

(2) Reduce acquisition costs and life-cycle costs of military systems.

c. The "potential interest" DFARS provision is less stringent than the former requirement of "military relevancy," which required the contractor to show that the project had a potential relationship to a military function or operation. The broader criteria lowered the audit risk on IR&D/B&P projects. Auditors should consider these broader criteria when developing their audit scope, particularly when deciding to request a technical evaluation.

d. The auditor should identify any development projects that may have entered the production phase. Production phase costs should be eliminated from

any IR&D project costs. IR&D projects that have been incurring costs for a long time should be reviewed to be determined if demonstrable progress is being made. These long-term projects should be brought to the attention of the contracting officer. In many cases, determination of reasonable progress cannot be made by the auditor without technical assistance.

e. Contractor contributions to cooperative research and development consortiums should be reviewed to determine whether the costs should be classified as IR&D or as consortium costs. Consortium costs are discussed in 7-1915.

f. The FAR states that costs for IR&D and B&P projects should be accounted for in the same manner as contracts and include all related direct costs and allocable indirect costs.

g. B&P costs, as defined in FAR 31.205-18(a), include all costs incurred in preparing, submitting, and supporting bids and proposals. CAS 420.50(a)(1) states the B&P project costs shall include costs that, if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective. Therefore, if a contractor charges administrative costs (such as, typing and technical support) directly to final cost objectives, then they must also charge them directly to B&P final cost objectives. If, however, the contractor charges administrative costs to indirect cost pools, such costs may continue to be charged to indirect cost pools. The auditor's review should include appropriate tests to assure consistent application of disclosed practices. In addition, the auditor should assure that the contractor's accounting practices for the treatment of administrative costs comply with CAS 410.30(a)(6), 410.50(d), 418.30(a)(3), and 418.50(b)(2).

h. Advance agreements may include a provision stating how the costs are to be allocated. In these cases the auditor should determine if the costs are properly classified and allocated in accordance with the agreement.

i. If the contractor's products are varied and a division of production and sales responsibility is clearly maintained, only IR&D and B&P costs of the profit center concerned with government con-

tracts should be considered for purposes of allocation to contract costs. As a general rule, IR&D and B&P costs shall be allocated to contracts on the same basis as the general and administrative expenses. Where specific projects clearly benefit other profit centers or the entire company, such costs shall be allocated through the G&A of such other profit centers or through the corporate G&A, as appropriate. The contracting officer may approve the use of a different base of allocation in those instances where allocation through G&A does not provide equitable cost allocation. The auditor's determinations regarding allocability will be included as part of the advisory report.

j. As part of ongoing risk assessment, auditors may periodically review and compare cumulative actual IR&D and B&P costs during the year with related ceiling amounts provided for in advance agreements or by the formula calculation to ascertain whether the actual annual expenditures will approximate the ceiling (see 6-404.6(b)(3)).

7-1504 Special Consideration for B&P Support Costs

a. B&P costs, as defined in FAR 31.205-18(a), include the costs of technical personnel engaged in the preparation and publication of cost and other administrative data necessary to support the contractor's bids and proposals. These administrative costs should be handled consistently with similar costs in the contractor's accounting system. In addition, the cost of technical personnel engaged in the development and preparation of the technical proposal document is to be separately identified and classified as direct B&P costs subject to allocation of all allocable indirect expenses, except for G&A.

b. FAR 31.205-18(a) and CAS 420 require the contractor to charge attendance at meetings in support of a bid or proposal by direct labor employees directly to the B&P project involved, unless the attendance is sponsored by a grant or required in the performance of a contract. Both FAR and CAS define bid and proposal costs as costs incurred in pre-

paring, submitting, and supporting bids and proposals (whether or not solicited) on potential government or non-government contracts. In addition, CAS 420.50(a) provides that IR&D and B&P project costs shall include costs that, if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective. Costs for direct labor employees attending a meeting at a government procurement office in support of a contract represent circumstances similar to direct labor personnel attending meetings in support of a bid or proposal. In the case of contract support, the direct labor personnel are interacting with procurement to perform work on a contract; in the case of a bid or proposal, the direct labor personnel are interacting with procurement to perform work on a bid or proposal (assuming that the attendance is not sponsored by a grant or required in the performance of a contract). The first situation is directly related to a contract; the second situation is directly related to a B&P project. Because the contract labor and related travel costs are charged directly to the contract, CAS 420.50(a) requires that the attendance at meetings in support of a bid or proposal and related travel costs be charged directly to the B&P project.

**7-1505 IR&D and B&P Allowability
Criteria for CFYs Beginning Before 1
October 1992**

a. FAR 31.205-18(c) requires any company receiving payments, either as a prime contractor or subcontractor, in excess of \$5.4 million from the government for IR&D and B&P in one of its fiscal years to negotiate an advance agreement with the government establishing a ceiling for allowability of IR&D and B&P costs for its following fiscal year. The 1991/1992 DoD Authorization Act increased the \$5.4 million threshold to \$7 million for contractor fiscal years beginning after 4 November 1990.

b. These thresholds include only those recoverable (allowable) IR&D and B&P costs allocated during the company's previous fiscal year to all government prime contracts and subcontracts for which the

submission and certification of cost or pricing data was required in accordance with Section 2306a of Title 10, U.S.C. (Truth in Negotiations Act).

7-1505.1 Definition of "Company"

The term "company" includes all divisions, subsidiaries, and affiliates of the contractor under common control. When a company meets the threshold, the required advance agreement may be negotiated at the corporate level and/or with those separate profit centers which in the preceding year allocated to government contracts recoverable IR&D and B&P costs in excess of \$675,000 (\$700,000 for CFYs beginning after 4 November 1990). Agreements negotiated at the corporate level may set individual ceilings for separate entities of the company.

**7-1505.2 Contractors Not Meeting
Criterion for an IR&D/B&P Advance
Agreement**

The FAR has two methods to determine the allowability of IR&D and B&P costs for contractors who do not meet the criteria for an advance agreement:

a. A formula is provided which takes into consideration the contractor's prior experience but allows for reasonable increases or decreases. The formula calls for three-year's prior history. If such prior history does not exist, then the formula is not applicable and reasonableness criteria at FAR 31.201-3 must be used.

b. An advance agreement may be negotiated, at the discretion of the contracting officer, if the contractor demonstrates that the formula would produce a clearly inequitable cost recovery.

**7-1505.3 Special Considerations for
Contractors Without Negotiated
Advance Agreements**

a. It was the contractor's responsibility to initiate negotiations when an advance agreement is required. The auditor should question all IR&D and B&P costs applicable to a fiscal year in which an

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advance agreement was required but was not negotiated.

b. When an advance agreement was not required, FAR similarly did not require the determination of potential interest to DoD (or prior to 19 August 1991, potential relationship to a military function or operation). The auditor will, however, determine that the costs are allocable, according to FAR 31.201-4.

c. When applicable, the FAR ceiling formula (deleted by FAC 90-13, effective 9/24/92) was based on the contractor's prior three-year experience. One calculation for the combined amount of IR&D

and B&P should be made. The offset provision previously included in the DAR cost principles was replaced with the calculation formula in the FAR which provided for one combined ceiling amount for IR&D and B&P. However, the contractor should account for IR&D and B&P separately and the auditor should continue to analyze IR&D and B&P separately. The combined calculated ceiling must fall within certain parameters (i.e., 80 percent and 120 percent of the average annual cost based on the two highest of the preceding three years). An example follows:

IR&D and B&P Costs			
	Sales (1)	Incurred (2)	Ratio
	\$	\$	%
1985	4,000,000	120,000	3.00 (*)
1986	6,800,000	200,000 (*)	2.94
1987	5,000,000	150,000 (*)	3.00 (*)
1988	4,500,000	150,000	
(*) Highest Historical Costs and Ratios Used in Averages			
1. Historical Ratio			3.00%
2. Average Annual Cost			175,000
Parameters			
3. 80% of Average Cost (80% of Line 2)			140,000
4. 120% of Average Cost (120% of Line 2)			210,000
5. Projected Ceiling (Line 1 times 1988 Sales)			135,000
Ceiling			
Calculated		140,000 (3)	
Proposed (1988)		<u>150,000</u>	
Amount Questioned		<u><u>10,000</u></u>	

(1) The regulation provided that a basis other than total sales may be used for this formula calculation if another basis is acceptable to the contracting officer. When a contractor proposes an alternate base, the auditor will review the contractor's rationale for the proposed base and include appropriate comments in the advisory audit report.

(2) The combined IR&D and B&P costs incurred for the preceding three-year period are the amounts determined as otherwise allowable before the determination of ceiling limitations resulting from application of the formula in prior years.

(3) The calculated ceiling must be within the 80 percent to 120 percent parameters. In this example the product

of the historical IR&D and B&P ratio and the current year sales is less than 80 percent of the average annual cost. Therefore the calculated ceiling would be 80 percent of the average annual cost.

7-1505.4 Special Considerations for Contractors With Negotiated Advance Agreements

a. A negotiated advance agreement results in the establishment of a combined IR&D and B&P ceiling amount for DoD participation. DFARS provides that the allowable amount of IR&D and B&P costs allocated to DoD contracts shall not exceed the lesser of (1) the allocable share of the negotiated ceiling

amount or (2) the total value of expenditures for those projects determined to have a potential interest to DoD (or prior to 19 August 1991, a potential relationship to a military function or operation.)

b. When difficulties are encountered in obtaining technical reports addressing military relevancy or potential interest to DoD, the auditor should notify the ACO responsible for these technical reports that the reports are required to determine the allowability of the IR&D and B&P costs.

c. At the end of the contractor's fiscal year, the actual incurred costs should be summarized for final comparison against the negotiated ceiling and determination of an allowable amount. An example follows:

EXAMPLE: Determining Cost Allowability at Various Levels of DoD Participation (in thousands)

Assumptions:	Ceiling Negotiated (1)	Incurred		Total
		Relevant (2) /Potential Interest	Nonrelevant (2) /No Interest	
IR&D/B&P	\$15,000	\$11,750	\$3,750	\$15,500

DoD Participation (3)	Negotiated amount for inclusion in indirect pool	Allocable to DoD per CAS 420	Allowable DoD allocation (4) per DoD FAR Supplement 231.205-18
100%	\$15,000	\$15,000	\$11,750
90%	\$15,000	\$13,500	\$11,750
80%	\$15,000	\$12,000	\$11,750
70%	\$15,000	\$10,500	\$10,500
60%	\$15,000	\$ 9,000	\$ 9,000
50%	\$15,000	\$ 7,500	\$ 7,500
40%	\$15,000	\$ 6,000	\$ 6,000
30%	\$15,000	\$ 4,500	\$ 4,500
20%	\$15,000	\$ 3,000	\$ 3,000
10%	\$15,000	\$ 1,500	\$ 1,500

(1) The ceiling is the maximum amount allowable for allocation to all work of that part of the company's operation covered by the advance agreement.

(2) When a contractor has initiated new projects, deleted projects included in the proposal from which the advance agreement was negotiated, or changed the emphasis of certain projects from that indicated in his technical proposal, an additional determination of potential interest to DoD (or prior to 19 August 1991, the potential relationship/relevance) will be necessary. This is because the second test of allowability is governed by the total of expenditures for projects determined to have a potential interest to DoD (or prior to 19 August 1991 the potential relationship to a military function or operation) (DFARS 231.205-18). When this circumstance is noted, the auditor should request a determination of relevancy from the responsible office.

(3) The DoD participation percentage is applied to the negotiated ceiling amount to determine the allocable costs to DoD contracts.

(4) The total allowable DoD allocation shall not exceed the total costs incurred on projects having a potential interest to DoD (or prior to 19 August 1991, a potential relationship to a military function or operation). If the total costs incurred on relevant projects exceed the total allocable to DoD, the allowable DoD costs will be limited to the allocable amount.

7-1506 IR&D and B&P Allowability Criteria for CFYs Beginning After 30 September 1992

7-1506.1 General Considerations

a. FAC 90-13 and DAC 91-4 implemented the requirements of Public Law 102-190. Those rules removed IR&D and B&P costs allowability ceilings from most contractors. The definition of IR&D and B&P costs changed by adding a sixth and a seventh specifically defined category of IR&D projects with "potential interest to DoD" to the list of such categories (see 7-

1503b). The allocation rules for IR&D and B&P were not changed.

b. The intent of the law and its implementing rules is to have IR&D and B&P costs treated as other costs are considered without specific ceiling limitations. The criteria for reviewing these costs will include allowability, allocability, and reasonableness.

c. For the vast majority of contractors previously covered by the old three-year formula ceiling, this ceiling was eliminated for CFYs beginning after 30 September 1992. See 7-1505 to determine which contractors were required to negotiate advance agreements for CFYs beginning prior to 1 October 1992. Contractors' segments with significant amounts of flexibly priced government contracts will continue to have a new type of ceiling on IR&D and B&P costs allocable to government contracts until the completion of the first three full CFYs beginning after 30 September 1992 (see 7-1506.2 and 7-1506.3). As those contractors complete their third CFY limited by the new ceiling rules, the specific ceiling limitations on each of those contractors will cease.

d. Under prior IR&D and B&P rules there was a risk that IR&D and B&P costs would be mischarged to cost-type contracts as the contractor neared its ceiling limitation for the year. That risk is lessened by the new FAR coverage. However, there is a continuing audit risk that IR&D performed directly for a contract may be mischarged from fixed price contracts or other flexibly priced contracts with a potential for cost overruns.

e. There is no ceiling limitation except reasonableness for any contractor that does not meet the \$10 million threshold (7-1506.2c), nor for any contractor segment that does not meet the \$1 million threshold (7-1506.2b), even if the contractor meets the \$10 million threshold.

7-1506.2 Determination of Contractor Segments Subject to a Ceiling Limitation

a. "Covered" contracts are government contracts (or subcontracts under a "covered" prime contract) for amounts in

excess of \$100,000, except for fixed-price contracts without cost incentives.

b. A "covered segment" is a segment of a company with over \$1 million of IR&D and B&P costs allocated during its prior fiscal year to "covered" contracts. IR&D and B&P costs of segments that are not "covered" are not counted in determining if a contractor meets the \$10 million threshold discussed below.

c. The ceiling applies (only for the first three CFYs beginning after 30 September 1992) to a contractor with over \$10 million of IR&D and B&P costs allocated during its prior fiscal year to "covered" contracts at its "covered segments."

d. Only the IR&D and B&P costs of "covered segments" of contractors exceeding the \$10 million threshold are subject to the new ceiling limitation.

7-1506.3 Calculation of Ceiling Limitation

a. The ceiling limitation is calculated using a new formula applied to actual costs incurred. The formula for the limitation on current year's cost begins with the allowable amount of IR&D and B&P costs incurred at "covered segments" during the previous year. To determine the ceiling amount the prior year's allowable amount is first automatically increased by 5 percent. The prior year's allowable amount is also increased by an additional percentage if the contractor incurs more for IR&D and B&P in the current year than it did in the prior year.

The additional increase is proportional to the contractor's spending increase, but is limited to the price escalation index for the Research, Development, Test, & Evaluation (RDT&E) account, Total Obligation Authority (TOA) published annually by the DoD Comptroller.

b. The RDT&E TOA indices are currently 2.6 percent for Government Fiscal Year (GFY) 1993, 2.7 percent for GFY 1994, 2.9 percent for GFY 1995, and 3.0 percent for GFY 1996. New rates will be provided to auditors as published by an MRD.

c. The following ceiling calculation example is for a calendar year contractor that had an advance agreement ceiling negotiated under the old cost principle, exceeds the \$10 million threshold for its covered segments for all years in the example, and has a constant 80 percent DoD negotiated contract share of the total business base. Its CFY 1993 would be the first year subject to the new cost principle's ceiling and its CFY 1995 would be the last. The example is provided assuming that all amounts are incurred costs. For forward pricing, the amounts would be projected. Because the ceiling amounts depend on prior years' actual costs, the actual limitations would change if the costs incurred differed from the projections. In the example, the negotiated ceiling for 1992 was \$30 million. All dollar amounts are in millions and represent only the costs allocable to "covered segments."

Costs Incurred at Segments Meeting

\$1 Million Threshold (note 3)	Amounts in Millions				
	1992	1993	1994	1995	1996
1. Incurred IR&D/B&P Costs	20.0	30.0	25.0	25.3	(note 1) 40.0
2. Prior Year's Allocable Amount	NA	20.0	21.5	22.6	NA
3. 5% Increase (5% of Line 2)	NA	1.0	1.1	1.1	
4. Percentage Increase in Costs *	NA	50.0%	0%	1.2%	
5. RDT&E TOA Escalation Index **	NA	2.6%	2.7%	2.9%	
6. Lesser of Lines 4 or 5	NA	2.6%	0%	1.2%	
7. Ceiling Increase Based on Spending Increase (Line 6 × Line 2)	NA	.6	0.0	NA	

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8. Ceiling (Line 2 + Line 3 + Line 7)	20.0	21.5	22.6	24.0	
9. Allowable IR&D/B&P (Lower of Lines 1 or 8) (note 4)	20.0	21.5	22.6	24.0	40.0
10. IR&D/B&P Costs with DoD Potential (note 2)	18.0	25.5	20.0	20.0	NA
11. Share of IR&D/B&P Allowable Under FAR Allocated to DoD (80% of Line 9)	16.0	17.2	18.1	19.2	NA
12. Allowable Total IR&D/B&P under DFARS for DoD Contracts (Lower of Lines 10 or 11)	16.0	17.2	18.1	19.2	NA

NA = Not Applicable

* = (Current Year - Prior Year) / Prior Year, But Not Less Than 0%

** The rates shown are from January 1994 projections and change annually.

Notes on the Example

(1) In the example for 1996, the contractor's IR&D and B&P costs are no longer subject to the ceiling limitations.

(2) Given the broad definition of "potential interest to DoD" in the DFARS, the risk is low that the costs would not meet the definition. If the amount on line 12 is ever less than the amount on line 10 for a year, there must be a lower IR&D-B&P rate calculated for allocation to DoD contracts to ensure that no more than the amount on line 12 is allocated to DoD.

(3) If the segments meeting the \$1 million threshold change from one year to the next, it may affect the contractor's \$10 million threshold coverage. The calculation of the current year's limitation on allowable costs must be based on the prior and current years' costs for the segments that are to be covered by the limitation being calculated.

(4) The ceiling calculated using the new FAR formula (FAC 90-13) must be increased if the contracting officer determines that the new ceiling formula would reimburse the contractor less than the contractor would have received under the rule prior to FAC 90-13.

7-1507 Special Consideration for NASA Contracts

The auditor must review the effective date of the contract to determine if the

contract is covered by the FAR or by the NASA Procurement Regulations. Special considerations are needed for contracts subject to the NASA Procurement Regulations.

7-1507.1 NASA Contracts Entered Into Under the FAR

The FAR provisions apply to all NASA contracts entered into on or after 1 April 1984. The NASA FAR Supplement has no special requirements for IR&D and B&P costs. Therefore, no special considerations are required for NASA contracts entered into under the FAR.

7-1507.2 NASA Contracts Entered Into Under the NASA Procurement Regulations (NASA PR)

a. The NASA PR generally applies to all NASA contracts entered into prior to the implementation of the FAR on 1 April 1984. The NASA PR cost principles covering IR&D and B&P costs are in conformity with the DAR cost principles in effect at the time for matters of definitions, burdening, and allocation procedures. Both sets of cost principles provide that IR&D and B&P costs are allowable to the extent that the costs are allocable and determined to be reasonable in amount. However, the NASA PR reflects somewhat different provisions regarding the determination of reason-

ableness and deferred IR&D costs as follows:

(1) The NASA PR cost principles do not establish any thresholds for entering into advance agreements, assign responsibilities for initiating negotiations, or provide any penalties for the failure to do so.

(2) Potential interest to DoD (prior to 19 August 1991, potential relationship to a military function or operation), or the NASA equivalent, is not a factor.

(3) There is no provision for formula calculation or comparable basis for determining reasonableness for contractors not considered major.

b. Clarification of the differences in allowability provisions between DAR and NASA PR follows:

(1) NASA PR has no requirement for potential interest or relationship (see 7-1503a). The ceiling amount negotiated by DoD should not be affected by the relevancy rule applicable to DoD inasmuch as nonrelevant projects are to be included in the total program base from which the ceiling is developed. Thus, NASA will normally accept, as in the past, its allocable share of expenditures for IR&D and B&P within the dollar ceiling negotiated by DoD and/or NASA under an advance agreement.

(2) NASA will be guided by the formula results accepted by the DoD contracting officer as reasonable in those cases where an advance agreement is not required.

(3) NASA reserves the right, as always, to withdraw its support from and/or participation in individual negotiations if it appears that NASA's best interests will be adversely affected by the terms and conditions of the proposed agreement. In such cases NASA will make a proper and timely notification of its decision to withdraw to all interested parties.

c. Accordingly, the following audit guidance is applicable to NASA PR contracts:

(1) Audit findings directed to NASA may be generally predicated on the same justifications as those used for DoD purposes except:

(a) When peculiar and unusual conditions exist at a particular contractor location with respect to NASA contracts;

(b) In those cases where an advance agreement is required by FAR, but the contractor has not initiated negotiations;

(c) When an advance agreement is required, negotiations have been held, but an advance agreement has not been reached and the contracting officer has substantially reduced payment below that which the contractor would otherwise have received; or

(d) In situations involving either deferred independent or sponsored research and development.

(2) Under these circumstances the audit report shall include all pertinent factual data, comments, and recommendations to assist the NASA contracting officer in reaching a conclusion.

7-1600 Section 16 — Warranty and/or Correction of Defect Costs**7-1601 Introduction**

a. This section covers the various warranty clauses that may be used in contracts awarded by the Federal government.

b. This section also presents general guidance in reviewing estimated and/or actual warranty costs and the various methods in accounting for warranty costs.

7-1602 FAR Warranty Clauses Affecting Warranty Costs

Warranty clauses or correction of defects clauses are included in some contracts to give the government certain rights and remedies if supplies or service furnished under the contract are found to be defective or deficient within a prescribed period. Generally, a warranty should provide that, for a stated period of time or use, or until the occurrence of a specified event, the government has a contractual right for the correction of defects (see FAR 46.702). The FAR and DFARS contain the following warranty clause requirements:

a. In implementing the requirements of the Defense Procurement Reform Act (10 U.S.C. 2403), the DoD issued DAC 84-9 to provide for a new Subpart 246.7 of the DoD FAR Supplement (DFARS). Subpart 246.7 requires the mandatory use of warranties in the procurement of weapons systems, unless a waiver is authorized. DFARS 246.770 contains the policies and procedures related to the use and waiver of weapons systems warranties.

b. Except for clauses governing cost-reimbursement supply contracts (FAR 52.246-3), cost-reimbursement research and development contracts (FAR 52.246-8), and the special requirements of weapon systems (DFARS Subpart 246.7), warranties are not included in cost-reimbursement type contracts (FAR 46.705).

c. FAR 46.703 provides criteria for determining whether a warranty is appropriate for a specific acquisition, other than in those situations discussed in paragraphs a. and b. above.

d. When a warranty is to be included in a contract, the terms and conditions may vary with the circumstances of the procurement. FAR 46.706(a) requires that the following items be clearly stated in the warranty clause:

(1) The exact nature of the item and its components and characteristics that the contractor warrants;

(2) The extent of the contractor's warranty including all of the contractor's obligations to the government for breach of warranty;

(3) The specific remedies available to the government, such as payment of the costs incurred by the government in procuring the items from another source, the right to an equitable reduction of the contract price, or that the contractor repair or replace the defective items at no additional cost to the government, and;

(4) The scope and duration of the warranty.

7-1603 Definition of Warranty Costs and Accounting for Such Costs

a. For purposes of the following guidance, the term "warranty costs" encompasses costs related to (1) the warranty aspects of the Inspection of Supplies and Correction of Defects clause and (2) warranty clauses. FAR 46.703(b) states that "Warranty costs arise from the contractor's charge for accepting the deferred liability created by the warranty. . . ." The acquisition cost of a warranty may be included as part of an item's price or may be set forth as a separate contract line item (see DFARS 246.703(b)). The warranty clauses specify that a contractor's cost of compliance with the provisions of the warranty will be at the contractor's expense with no increase in contract price. The phrase "at no additional cost to the United States," as used in the various warranty clauses, means at no increase in price for firm fixed price contracts, or at no increase in target or ceiling price for fixed price incentive contracts, or at no increase in estimated cost or fee for cost-reimbursement contracts (see DFARS 246.770-1).

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b. The audit of estimated or incurred warranty costs is dependent upon the terms of the contracts and the contractor's accounting policies and procedures. Warranty costs may be accounted for (1) as a direct contract cost, (2) as an indirect cost on the basis of actual expenditures in the period of incurrence, or (3) as an indirect cost on the basis of establishing a reserve. The use of this last method is similar to that generally used in accounting for bad debt losses.

7-1604 General Audit Considerations

The following points should be considered when evaluating warranty costs included in contractors' cost submissions or pricing proposals:

a. If the contract includes warranty coverage, the clause should be examined to determine the period covered by the warranty, the warranty terms, and that the warranty costs reviewed are allowable under the contract. Contractor's costs of compliance with the warranty terms are generally to be at the contractor's expense with no increase in contract price or cost allowed. When express warranties are included in contracts (except contracts for commercial items) all implied warranties of merchantability and fitness are negated by use of the language in the warranty clause (see FAR 46.706(b)(1)(iii)). Under cost-reimbursement type contracts, the Inspection of Supplies and Correction of Defects clause provides that corrections or replacements are to be made without cost to the government if the defects are the result of fraud or other causes of the types listed in FAR 52.246-3(h). In the absence of such causes, costs of correcting defects may be allowable if incurred within the period covered by the clause.

b. Verify actual costs to ensure that contractors have properly segregated warranty costs for the correction of defects from the costs of ongoing performance (such as redesign, rework, test and quality control). In many cases, the department or group tasked with correcting a defect under the warranty requirements will be the same department or group performing the ongoing portion of the contract. The auditor should ascertain whether the

contractor has established procedures for reviewing items processed for correction of defects and for determining the reason(s) for the defects and the extent of its responsibility. In some cases, where costs are relatively large, the auditor may obtain technical advice from government technical personnel prior to accepting such costs.

c. Determine whether the contractor's policies and procedures for allocating warranty costs are equitable and give effect to any existing significant differences in warranty conditions or costs among the various items or product lines produced by the contractor. For example, if a contractor produces several items or product lines which have significant differences in types of warranties offered, or in the warranty costs incurred, the auditor should ascertain that the basis of allocation to the particular items or product lines appropriately reflects these differences. When warranty costs are included in overhead, the auditor should determine that the base for allocating this expense is made up only of contracts containing warranty provisions. When evaluating direct charges to a contract for warranty costs, the auditor should ascertain that the same type of costs incurred on other government or commercial products are excluded from allocable overhead unless it is clearly established that a cost duplication does not exist.

d. Determine whether the contractor's policies and procedures are being followed and properly implemented. To ascertain this, a representative number of transactions should be reviewed. When warranty costs are accounted for under the reserve method, the auditor should ascertain that the periodic charges to overhead and additions to the reserve account are not excessive in relation to actual warranty costs experienced over an appropriate number of years.

e. In estimating costs to provide a warranty, contractors must consider many factors, including the specific warranty terms, the types of defects which may occur, the probability and number of occurrences, and the nature, extent, and cost of the corrective action which will be required. In the evaluation of

proposed warranty costs, the following steps should be performed:

(1) Review the warranty provisions in the request for proposal to ascertain that a warranty is required and to determine the nature and extent of the warranty requirements.

(2) Evaluate the contractor's accounting policies and procedures for the treatment and segregation of warranty costs. Review the practices to determine if any inequity exists in allocating costs between and among commercial and government work loads.

(3) Determine the basis of the proposed warranty costs. The estimates should be based on auditable data such as actual experience, industry-wide experience, actuarial estimates or parametric estimates [see 9-1000]. If estimated costs are predicated on incurred costs related to isolated events which are nonrecurring, a contingency exists; therefore, attention should be given to FAR 31.205-7, "Contingencies."

(4) Evaluate the contractor's past experience in the actual incurrence of warranty cost.

(5) Determine if there are any discernible trends or changes in accounting or operating practices which are likely to affect warranty costs in future periods.

(6) Determine that warranty costs charged direct on prior contracts are excluded from the base amounts used to project future product costs on follow-on contracts.

(7) When the examination relates to a proposal for a contract where a warranty may be appropriate (see 7-1602), the audit report should include any comments which would assist the contracting officer in determining (a) whether the best interest of the government would be served by including a warranty clause in the contract, (b) the approximate cost to the government for the protection afforded by such clause (the amount not questioned), and (c) whether major subcontracts include warranty provisions. If so, the report should also include comments on vendor warranty costs, particularly in cases where the express or implied contractor or vendor policy is that vendor warranties will not be passed to the government. This may require an assess-

ment of (i) the dollar impact of warranty costs included in vendor prices, and (ii) the need for the contractor to have warranty protection when material is purchased for inventory or for other prudent reasons. Where determinable, the report should include a statement to the effect that the contractor's proposal costs include amounts for either vendor or contractor warranty, even though the dollar impact may not be quantifiable.

(8) When the examination relates to a proposal for a contract excluded from the inclusion of a warranty clause (See 7-1602), comments similar to those provided in (7) above would not be appropriate. However, those contractor proposals may contain an "inspection clause," and should include a reasonable estimate for costs of complying with the requirements of the related contract clause (see FAR 52.246). The omission or understatement of such costs may result in the negotiation of a contract with a built-in overrun factor. If the auditor encounters an apparently inappropriate omission, this should be brought to the attention of the contractor and the appropriate contracting officers. The auditor should not prepare the proposed estimate for the contractor. However, the auditor should disclose any deficiency in the narrative report comments with attention to the appropriate contractor responsibilities addressed at FAR 46.105, 46.202 and 46.3.

f. Other Audit Considerations

Other areas that may require special consideration in the audit of warranty costs include CAS adequacy and compliance and the use of off-site indirect expense pools.

(1) Prior to the implementation of the DoD warranty requirements for weapon systems contracts (see 7-1602), many contractors treated warranty costs as an indirect cost which was allocated to all applicable final cost objectives. As a result of the warranty requirements under DFARS 246.770-2, which became effective 1 January 1985, contractors may be charging the warranty costs directly to final cost objectives. If the contractor's disclosed practices state that warranty costs are to be treated as an indirect cost, a revision to the disclosure

statement will be required (see 8-303). In addition, consideration must be given to the requirements of CAS 402 which requires consistency in the allocation of costs incurred for the same purpose in like circumstances (see 8-402).

(2) Another audit concern resulting from the inclusion of warranty clauses in contracts relates to the use or establishment of off-site overhead pools to accumulate and allocate expenses related to effort of correcting defects at off-site locations (for example, correction of a defect at a government installation). The audit of costs associated with off-site activities would include a determination of whether the effort is of such magnitude as to justify establishment of a separate cost pool, and whether the allocation method used satisfies the requirements of FAR 31.203 and, if applicable, CAS 418 (see 6-606 and 8-418).

7-1605 Coordination with the ACO and Technical Staff

The technical nature of the subject matter and the relevancy of interpreta-

tion of contract provisions on warranty costs make it especially important that the auditor coordinate with the ACO and the ACO's technical staff.

7-1606 Audit Considerations in Negotiating Final Price under an FPI Contract

The final total price negotiated under a fixed-price incentive contract containing a warranty clause may consider all costs incurred or to be incurred by the contractor in complying with the warranty clause (see FAR 46.707). When it is the contractor's practice to account for warranty cost as a direct charge or by establishing a reserve (see 7-1603 b), its repricing proposal for the above purpose may include an estimate of warranty costs remaining to be incurred. In such cases the auditor should examine closely the basis for the estimates and their reasonableness.

7-1700 Section 17 — Business Combination Costs**7-1701 Introduction**

This section provides guidance for audit evaluation of business combination costs proposed or claimed by contractors.

7-1702 Business Combinations

a. A business combination occurs when a corporation and one or more incorporated or unincorporated firms are brought together under common control, generally into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises (see APB-16).

b. Once an auditor becomes aware of a business combination whether it be through a merger, consolidation, acquisition, divestiture, etc., he/she should take the following steps:

(1) Contact the contractor immediately to obtain information on the situation.

(2) Request that the contractor keep DCAA advised of all related transactions and activities as they occur.

(3) Remind the contractor of the FAR and CAS requirements concerning affected costs, including the requirement that unallowable costs together with directly associated costs be identified and excluded from any claim applicable to the government.

(4) Maintain contact between and among the affected FAOs to assure a complete exchange of information, and to ensure that consistent audit action is being taken. Where there is a Contract Audit Coordinator (CAC) or a Corporate Home Office Auditor (CHOA) (CAM 15-200), overall coordination responsibility should reside therein.

(5) Contact the ACO and the major buying commands to ensure that they are aware of the circumstances. There should be a complete exchange of information with emphasis on items such as advance agreements and novation agreements.

(6) Evaluate the benefits of having a CAC or CHOA conference or a meeting of the auditors cognizant of the specific organizational units involved in the change.

7-1703 Basic Approaches to Obtaining Control Over Assets Owned and Used by Other Firms

There are two basic approaches to obtaining control over assets owned and used by other firms. The acquiring firm may buy the desired assets and thereby obtain title to their use directly, or it may obtain an ownership interest in the common stock of another company enabling it to exercise indirect control over the other firm's assets. These two basic approaches can be adopted in various forms, as follows:

- a. Acquisition of assets.
- b. Acquisition of stock.
- c. Statutory merger.
- d. Statutory consolidation.

7-1703.1 Acquisition of Assets

a. The acquisition of assets under a business combination is more than a casual sale and purchase of an asset. It is the purchase and sale of a major amount of operating assets, requiring approval by each company's board of directors and, generally, its stockholders. Payment for the assets may be made by cash, debt securities, the acquiring firm's stock, or a combination thereof.

b. The acquiring corporation may (1) create a new corporation for the assets, (2) assign the assets to a new division or branch, or (3) assimilate the assets into its present organization. An important point to bear in mind is that purchasing the assets does not give the acquiring firm any ownership rights in the selling organization. The acquiring firm is buying title to specific assets and is in no way acquiring any stockholders' rights in the selling firm.

7-1703.2 Acquisition of Stock

Instead of buying assets directly, an acquiring firm may gain control of assets by buying the voting common stock of the investee. Voting stock may be acquired by (1) purchase of outstanding stock on the open market, (2) negotiation with major stockholders to purchase all or part of their interests, (3) purchase of

authorized but unissued shares (including treasury stock) from the investee company, and (4) a tender offer. In a tender offer, the investor makes a public announcement to the stockholders of the corporation whose stock the investor wishes to purchase. The announcement stipulates the price offered for the shares and the number of shares the potential investors want to purchase, what will happen if more or less than that number are tendered, and the time period for tendering the stock. Information regarding the tender offer must be filed with the Securities and Exchange Commission prior to making the offer.

7-1703.3 Statutory Merger

A statutory merger occurs when one or more corporations give up their separate legal identities to another constituent corporation which maintains its identity. Stockholders of the liquidated corporation usually receive common stock of the surviving corporation, but they may also receive cash, debt securities, or preferred stock. Normally, a statutory merger must be approved by the boards of directors of the constituent corporations and then by the stockholders of each company.

7-1703.4 Statutory Consolidation

A statutory consolidation is similar to a statutory merger in that the consolidation must be approved by the boards of directors and stockholders of the constituent corporations. Unlike a merger, however, a consolidation results in the formation of a new corporation and the liquidation of the constituent corporations. The shareholders of the constituent corporations are issued stock in the new corporation, which then controls the assets and liabilities of the former constituent corporations.

7-1704 Purchase and Pooling of Interests Methods of Accounting for Business Combinations

7-1704.1 Introduction and Use

There are two generally accepted methods of accounting for a business combination: the pooling of interests method and the purchase method. Although

equally acceptable, the methods cannot be used alternatively. That is, a business combination must meet certain requirements to qualify as a pooling of interests; if it does not meet the requirements it must be treated as a purchase. Part-purchase and part-pooling of the same business combinations is unacceptable (APB-16, Accounting for Business Combinations). Because of the restrictive GAAP requirements, the pooling of interests method is rarely used. The conditions required for use of the pooling of interests method are specified in APB-16.

7-1704.2 Pooling of Interests Method.

a. The pooling of interests method reflects the union of ownership between the entities involved. The pooling is accomplished primarily through the issuance of common stock of the acquiring company. Goodwill is never recorded in a pooling of interests because the assets and liabilities of the companies involved are carried forward at their recorded amounts. In short, they are viewed as always having been one entity.

b. Asset Valuation. Under the pooling of interests method, the assets and liabilities of the separate companies become the assets and liabilities of the combined corporation. The value of each asset and liability, as recorded under GAAP on the books of the separate companies at the date of combination, is the value that is carried over to the books of the combined company (see APB-16).

7-1704.3 Purchase Method

a. The purchase method reflects the acquisition of one company by another. The excess, if any, between the fair value of the identifiable assets purchased and the amount paid is recorded as goodwill.

b. The effect of using the purchase method on the valuation of acquired assets is stated in paragraph 8 of APB-16: "The cost to an acquiring corporation of an entire acquired company should be determined by the principles of accounting for the acquisition of an asset. That cost should then be allocated to the identifiable individual assets acquired and liabilities assumed based on their fair values; the unallocated costs should be recorded as goodwill."

c. For more specific guidance relating to the valuation or write-up of assets under the purchase accounting method, see 7-1705 below.

7-1705 Asset Valuation and Revaluation Under the Purchase Method of Accounting for Business Combinations

7-1705.1 Introduction to Asset Write-ups (or Write-downs)

a. In a business combination that is accounted for as a purchase, a write-up (or write-down) of the asset values can occur when the purchase price paid for the assets or the capital stock is more (or less) than the book value of the assets. Under GAAP, the amount of the write-up is limited to the lower of the assigned purchase price or the fair market value of the acquired assets (7-1705.2). Costs assigned to intangible assets should reasonably reflect their fair market value (7-1705.3).

b. Asset write-ups (or write-downs) may occur through either the direct purchase of assets (7-1705.4) or through the purchase of stock when the acquired company is liquidated (7-1705.5).

c. Costs relating to asset write-ups in accordance with CAS (or GAAP) are generally allowable for contracts entered into before 23 July 1990. Credit adjustments for excess depreciation costs charged to government contracts should reflect equitable treatment for all parties and should be recognized as liabilities in the revaluation process (7-1705.6).

d. For contracts entered into after 22 July 1990, the amounts of amortization, depreciation, and cost of money that are assigned in accordance with CAS (or GAAP), are subjected to a ceiling for allowability purposes. The ceiling is the amount that would have been allowable had the combination never taken place (see FAR 31.205-52). This allowability criteria applies even if the business combination was prior to 23 July 1990 (7-1705.7).

e. The asset values determined in accordance with CAS (or GAAP), are used in the three-factor formula for distributing home office costs. Likewise, depre-

ciation and amortization costs assigned in accordance with CAS will be included in any allocation base which normally includes such costs, e.g., the total cost input base. To the extent that such costs are unallowable, the inclusion of such costs in an allocation base will cause the unallowable portion of the costs to absorb a portion of overhead cost or G&A expense.

f. Goodwill is an expressly unallowable cost. Also, goodwill is an unallowable element of the facilities capital employed base used to compute cost of money.

7-1705.2 GAAP for Write-ups (or Write-downs)

a. The GAAP for determining the value of an acquired company's assets are principally provided in Opinion of the Accounting Principles Board (APB) 16. Three paragraphs are restated below.

(1) Paragraph 68 - Allocating Costs. Acquiring assets in groups requires not only ascertaining the cost of the assets as a group, but also allocating the cost to the individual assets which comprise the group. The cost of a group is determined by the principles in paragraph 67. A portion of the total cost is then assigned to each individual asset acquired on the basis of its fair value. A difference between the sum of the assigned costs of the tangible and identifiable intangible assets acquired, less liabilities assumed, and the cost of the group is evidence of unspecified intangible values.

(2) Paragraph 87 - Recording Assets Acquired and Liabilities Assumed:

(a) An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed. Allocation should follow the principles described in paragraph 68.

(b) First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.

(c) Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets

acquired, less liabilities assumed, should be recorded as goodwill. The sum of the market or appraisal values of identifiable assets acquired, less liabilities assumed, may sometimes exceed the cost of the acquired company. If so, the values otherwise assignable to noncurrent assets acquired (except long-term investments in marketable securities) should be reduced by a proportionate part of the excess to determine the assigned values. A deferred credit for an excess of assigned value of identifiable assets over cost of an acquired company (sometimes called "negative goodwill") should not be recorded unless those assets are reduced to zero value. (For further explanation on negative goodwill, see b. below.)

(d) Independent appraisals may be used as an aid in determining the fair values of some assets and liabilities. Subsequent sales of assets may also provide evidence of values. The effect of taxes may be a factor in assigning amounts to identifiable assets and liabilities (paragraph 89).

(3) Guides for assigning amounts of the purchase price to individual categories of assets and liabilities assumed are provided in paragraph 88 of APB-16 and summarized below:

(a) Inventories - net realizable value, less a reasonable profit, except raw material, which should be valued at current replacement cost.

(b) Receivables - present value of the amount that will be received, less an allowance for uncollectible accounts.

(c) Marketable securities - net realizable value.

(d) Plant and equipment - appraised values in accordance with intended use.

(e) Liabilities - present value of the amount to be paid.

b. In the event the assignable fair values of net assets acquired exceed the purchase price, the value of noncurrent assets acquired (excluding long-term investments in marketable securities) should be reduced proportionately. Negative goodwill (any remaining cost) should not be recorded unless all the noncurrent assets acquired (excluding long-term investments in marketable securities) have been reduced to zero. Current assets are those which will be realized in cash, or

sold or consumed during the operating cycle of the business (Accounting Research Bulletin (ARB) 43, Chapter 3, paragraph 4). The operating cycle is the average time intervening between the acquisition of materials or services entering the production process and final cash realization (ARB-43, Chapter 3, paragraph 5).

c. Further guidance on the proper procedures for writing up assets is contained in Section 7610 of the "AICPA Technical Practice Aids."

7-1705.3 Intangible Assets

a. Intangible assets are generally grouped into two categories: identifiable and unidentifiable. Identifiable intangible assets are given reasonably descriptive names such as patents, trademarks, and franchises. Conversely, unidentifiable intangible assets lack specific identity. The excess amount paid for an acquired company over the sum of identifiable net assets, usually termed goodwill, is the most common unidentifiable intangible asset. The most significant distinction between the two categories is their separability. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire company. Unidentifiable intangible assets are inseparable from the entity and therefore cannot be acquired singly.

b. Costs should be assigned to all specifically identifiable assets, normally based on the fair values of the individual assets; costs of identifiable assets should not be included in goodwill or any other type of unidentifiable assets (see APB-17). The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired, less liabilities assumed.

c. In a purchase transaction, the assets of the acquired company are appraised and current market values established. Usually, outside appraisers perform the appraisal. They may take several different approaches in arriving at their estimates. While (1) the accounting processes prescribed by APBs 16 and 17 require the assignment of costs to identifiable assets,

and (2) GAAP prescribes recognition of the assigned cost, the auditor should not automatically conclude that the resulting costs are reasonable and reimbursable.

d. The auditor needs to evaluate the contractor's categorization of each identifiable intangible asset to determine whether or not the value assigned to such asset is reasonable and commensurate with economic reality or substance of the asset in review. The allowability of identified assets should be limited to fair market values subject to allocability and reasonableness tests.

7-1705.4 Write-ups Resulting from the Direct Purchase of Assets

a. If a business combination results from the direct purchase of assets: (1) GAAP obligates the acquiring firm to record the assets at amounts which reflect the actual price paid for the assets (see 7-1705.2); (2) the adjusted asset amounts are reflected on the books of the acquired company (assuming it continues as a separate operation); and (3) the government recognizes the adjusted amounts for contract cost accounting purposes (but see 7-1705.7 and 7-1705.8).

b. The amounts assigned to the purchased assets can vary considerably from the book values of the assets on the acquired contractor's accounting records. Normally, the assigned amounts are greater, indicating that the purchase price exceeded the book value of the acquired assets. The assigned amounts can also be lower, however, if the book value of the acquired assets exceeded the purchase price.

c. The auditor should also understand that the amount of write-up or write-down recognized by the acquiring company (i.e., the difference between the new assigned values and the old book values of the acquired company's assets) also represents the amount of the selling company's gain or loss on the disposition of depreciable assets. For further guidance, see FAR 31.205-16, Gains and Losses on Disposition of Depreciable Property or Other Capital Assets. Also see 7-1705.6.

7-1705.5 Write-ups (or Write-downs) Resulting from the Purchase of Stock and Liquidation of the Acquired Company

a. If the business combination of two corporations is achieved through the pur-

chase of stock, no write-up of assets is permissible on the acquired corporation's accounting records, unless the acquiring corporation elects to liquidate the acquired corporation. This is an important distinction from the direct purchase of assets. It is based on how the courts view the corporate entity and the ownership of assets. That is, in a stock purchase without liquidation of the acquired corporation, the courts have determined that (1) the assets held by the acquired company after the stock purchase are the same assets as those held before the stock purchase and (2) it is the acquiring corporation, not the acquired corporation, which has incurred the costs to purchase the stock and assets of the acquiring corporation.

b. Consistent with the position above, in a stock purchase without liquidation, the difference between the book value and purchase price of the acquired company's assets is reflected on the books of the acquiring company, not the acquired company.

c. The auditor should challenge contractor attempts to write up the assets of a corporation which was acquired through a stock purchase, but not liquidated. This includes write-ups that are deemed to be appropriate based on a contractor's tax election under Section 338 of the Internal Revenue Code. Prior to Section 338, the IRS prescribed liquidation techniques to support an actual dissolution of a company before its assets could be stepped-up. The IRS no longer requires this procedure; however, an important aspect of Section 338 is the recapture provision and other taxable treatment comparable to that applicable when a purchased subsidiary was liquidated under prior laws. This recapture provision is comparable to the mechanism available to the government in adjusting contracts at CAS 409.50(j)(1) and FAR 31.205-16.

d. In the Marquardt Co. case, (ASBCA No. 29888, 85-3 BCA para. 18245) which was upheld by the Federal Circuit Court in 1987 (822 F.2d 1573), the Board ruled that a contractor acquired in a business combination was not entitled to use the purchase method prescribed by CAS 404.50 in order to revalue its assets for

government contract costing purposes. The asset revaluations were disallowed because the acquired company (Marquardt) continued to exist unchanged as a wholly owned subsidiary of the acquiring company. The Board decided that the accounting method prescribed by APB-16 applies to how an acquiring business is to value its assets and that the write-up in asset values is not recoverable on government contracts held by the acquired business.

7-1705.6 Credits Due the Government When Assets Are Written-up Under the Purchase Method of Accounting for Business Combination

a. Generally, costs of write-ups are allowable for contracts issued before 23 July 1990, provided that the assets are written up in accordance with the GAAP and subject to FAR cost principle limitations (see 7-1705.7 and 7-1705.8).

b. It is DCAA's position that an adjustment for the depreciation costs charged to government contracts is required whenever all of the following occur: (1) one company with government contracts is acquired by another through either a direct purchase or stock purchase with liquidation; (2) the purchase price of the assets is materially more or less than the book value of the assets; and (3) there is no advance agreement between the involved parties and the government that would preclude such an adjustment. This position is based on the related provisions of CAS 409.50(j)(3) and FAR 31.205-16(e), which deal with gains and losses arising from the mass or extraordinary sale of assets. The adjustment itself represents the difference between the net book value of the acquired assets (at the time of liquidation/merger) and the appraised market value of the assets (at the time of purchase by the acquiring company), up to the amount of depreciation expense taken by the acquired company. It is similar in theory to the depreciation that is recaptured under Sections 1245 and 1250 of the Internal Revenue Code.

c. CAS 409.50(j)(3) and FAR 31.205-16(e) further stipulate that the contracting parties account for gains and losses on the mass sale or disposition of assets in a manner that results in equitable

treatment to all parties. Parties seeking equity on the mass sale or disposition of assets on the basis of these provisions are not then compelled to comply with the other provisions of CAS 409 and FAR 31.205-16 governing the routine sale or disposition of one or more tangible capital assets.

d. When an adjustment to the costs of government contracts is warranted because of the mass sale and write-up (or write-down) of assets, it should be pursued first through the contracts of the selling company (i.e., the company which experienced the gain or loss on the sale of the assets for tax purposes). If the adjustment was not considered by the selling company, and the buying company acquired the contracts of the selling company (as well as the assets), then the adjustment should be viewed (and pursued) as an obligation of the buying company. The reason for this is that the buying company becomes the proper successor company for contractual performance and, as such, it assumes all of the contractual rights, duties, and obligations of the selling company.

e. Adjustments due on the write-up of assets should be recognized as liabilities in the revaluation process and should serve to reduce the dollar amount remaining to be assigned to identifiable assets using procedures prescribed by APBs 16 and 17. For assets written up in this manner, the resulting depreciation and cost of money will be allowable on future (non-novated) contracts based on the appreciated cost of the asset.

7-1705.7 Allowability of Asset Valuation Write-ups for Contracts Issued After 22 July 1990

a. For business combinations that use the purchase method of accounting, FAR 31.205-52 (Asset Valuation Resulting from Business Combinations) limits the amount of allowable amortization, depreciation, and cost of money to the total amount that would have been allowable had the combination never taken place. This provision became effective 23 July 1990. Simply stated, the government will not recognize for cost allowability purposes any costs resulting from the increase in the value of acquired assets (or

the creation of new assets) as a result of business combinations. FAR 31.205-52 applies to contracts awarded on or after 23 July 1990. For purposes of pricing and costing contracts entered into after 22 July 1990, this FAR provision also applies to preexisting business combinations that predate the effective date of the cost principle. However, the contracting officer may need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the government's interest in special situations (see 7-1705.7.d.).

b. Except when the business combination results in an asset write-down, the allowability of costs will usually be based on the acquired company's book values for the existing assets before the combination took place. The contractor is responsible for maintaining the proper documentation to demonstrate that the proposed or claimed costs do not exceed the amounts calculated based on the book values of the acquired assets. This becomes particularly important in those business combinations when one company purchases another company and the acquired company is dissolved.

c. An exception exists in those cases when the assigned values of noncurrent assets are adjusted downward (purchase price is less than net fair value). In these situations the basis for determining allowable costs will be limited to the book value or the adjusted value, whichever is lower. This is in accordance with CAS 404. More specifically, CAS 404.50(d) provides that when the fair value of assets less liabilities exceeds the purchase price of the acquired company under the purchase method of accounting, the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess. The government cannot allow costs that are not assignable to a cost accounting period under the CAS requirements. Therefore, prior book values in excess of the price paid by the contractor are unallowable.

d. Auditors who encounter the following situations should advise the contracting officer that an advance agreement may be necessary to provide equitable treatment to both the government and

the contractor and to minimize future disputes:

(1) when the government, prior to 23 July 1990, had agreed to a settlement covering a business combination which implied acceptance of such costs in the future. For example, when the government had agreed to accept an immediate credit for excess depreciation and amortization costs recognized prior to the business combination;

(2) when the acquired company had no or little government business before being acquired so that no material credit exists for excess depreciation and amortization previously recognized, and the acquiring company subsequently entered government business with the asset valuations established by the combination.

(3) when an extensive period of time has elapsed between a prior business combination and the effective date of the cost principle. A reasonable period of time (e.g., five to ten years) may need to be considered in applying the limits of FAR 31.205-52.

e. Gains and losses on the disposition of assets resulted from a business combination shall not be recognized as specified at FAR 31.205-16(a).

7-1705.8 Unallowable Costs

a. Goodwill. FAR 31.205-49 defines goodwill as an unidentifiable intangible asset. It originates from use of the purchase method of accounting for a business combination. Goodwill arises when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. Goodwill may arise from the acquisition of a company as a whole or in part. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.

b. Cost of Money. The cost of money resulting from including goodwill (however represented) in the facilities capital employed base is unallowable (see FAR 31.205-10(a)(5)).

7-1705.9 Summary of Audit Guidelines for Write-ups

a. For contracts issued before 23 July 1990, the auditor must be assured that

the individual assets are valued properly in accordance with APBs 16 and 17, and that the contractor is correctly accounting for the gains and losses.

For example, the auditor needs to verify that (1) the purchase price is correctly stated, (2) the transaction qualifies for the purchase method of accounting, (3) all tangible and intangible assets are included on the balance sheets, (4) the appraised values are reasonable and recorded in accordance with the aforementioned procedures, and (5) the assets are properly categorized as current or non-current.

The auditor should review the purchase agreement and other documents provided in connection with the novated contracts, the appraisal report(s), and certified financial statements. If the write-ups are material in amount, consideration should be given to requesting a technical evaluation of the appraisal amounts.

b. For contracts issued after 22 July 1990, the auditor should verify that contracts do not receive increased costs flowing from asset revaluation resulting from business combinations. This would also apply to preexisting business combinations that predate the contracts being entered into. The auditor may have to advise the contracting officer of the need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the government's interest in special situations.

7-1706 Novation Agreements

a. A successor in interest to a government contract usually evolves from a change in the ownership of a contractor organization. The successor in interest is recognized by a novation agreement executed by (1) the contractor (transferor), (2) the successor in interest (transferee), and (3) the government. By the novation agreement, among other things, the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the government recognizes the transfer of the contract and related assets (FAR 42.1201). Novation agreements are en-

tered into for all executory contracts transferred to a successor in interest.

b. The transfer of a government contract is prohibited by law (41 U.S.C. 15). FAR 42.1204(a) states: "However, the Government may, in its interest, recognize a third party as the successor in interest to a Government contract when the third party's interest in the contract arises out of the transfer of (1) all the contractor's assets or (2) the entire portion of the assets involved in performing the contract." Examples include, but are not limited to:

(1) Sale of the assets with a provision for assuming liabilities.

(2) Transfer of the assets pursuant to merger or consolidation of a corporation.

(3) Incorporation of a proprietorship or partnership or formation of a partnership.

c. When it is in the government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the government, and the contract may be terminated if the original contractor does not perform (see FAR 42.1204(b)).

d. When a contractor requests the government to recognize a successor in interest, the contractor is required to submit a signed novation agreement. The form of the novation agreement and the conditions for its use are prescribed in FAR 42.12.

e. The authorized agreement provides in part that "The Transferor and the Transferee agree that the Government is not obligated to pay or reimburse either of them for, or otherwise give effect to, any costs, taxes, or other expenses, or any related increases, directly or indirectly arising out of or resulting from the transfer or this Agreement, other than the Government in the absence of this transfer or Agreement would have been obligated to pay or reimburse under the terms of the contracts" (see FAR 42.1204(e)(b)(7)). Auditors should be aware that the cited provision is not limited to professional services, taxes, and corporate expenses directly connected with the change in ownership. For novated contracts, it bars any increase in contract costs that would otherwise not

have occurred. This applies not only to total cost of performance but to any element of cost. The Armed Services Board of Contract Appeals barred an *increase in depreciation* resulting from a revaluation of assets by the new owners (LTV Aerospace Corporation, ASBCA No. 11161, 67-2 BCA para. 6406). In that case, the Board also rejected a contention that the claim was proper as an offset for "savings" resulting from decreases in other cost categories such as reduced state income taxes resulting from increased depreciation. The "savings" were not costs under the contract because they were never incurred by the contractor.

f. Auditors need to review each novation agreement to determine its accounting impact on the applicable contracts, the concurrently running contracts, and those contracts entered into subsequent to the agreement.

7-1707 Organization and Reorganization Costs

a. Expenditures made in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, are unallowable under FAR 31.205-27, Organization Costs (see Dynallectron Corporation, ASBCA 20240, 77-2 BCA 12835). Such expenditures include, but are not limited to, incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors, whether or not they are employees of the company. This would also include costs related to changes in the financial structure which may result from divestitures or the establishment of joint ventures or wholly-owned subsidiaries. In establishing the coverage at FAR 31.205-27, the Cost Principles Committee relied on the following definition of an organization and reorganization and the costs thereof:

(1) A major change in the financial structure of a corporation or a group of associated corporations resulting in alterations in the rights and interest of security holders; a recapitalization, merger, or consolidation.

(2) Any costs incurred in establishing a corporation or other form of organization; as, incorporation, legal and accounting fees, promotional costs incident to the sale of securities, security-qualification expense, and printing of stock certificates.

b. In the event a contractor creates or acquires a new segment or business unit through an acquisition or reorganization, the auditor should review the activity associated with the transaction to determine if any unallowable or unallocable costs are assigned to government contracts. These activities are often performed by an in-house business planning group, an acquisition and divestiture committee, and by the corporate legal and accounting departments. The auditor should review any available documentation to identify activities and associated costs which are directly incident to establishing or altering the contractor's financial structure. Many times the employees involved in these activities do not maintain adequate time records to identify and support their effort expended on reorganizations and related work. The auditor should ensure that the contractor implements the necessary policy and procedures to properly identify and account for these activities.

c. Normal recurring expenditures associated with internal reorganizations of contractor segments and divisions are generally allowable costs to the extent they are reasonable and allocable. Such expenditures may be incurred for business planning and forecasting, developing policies and procedures, preparing a CAS disclosure statement, establishing an accounting system, etc.

7-1708 Costs Associated With Resisting Change in Ownership

7-1708.1 General Allowability

a. For contracts awarded prior to 4 April 1988, contractor expenditures to resist a takeover should be disapproved in accordance with the provisions of both FAR 31.205-27, "Organization Costs," and FAR 31.205-28, "Other Business Expenses." In addition, the auditor should:

7-1708.1a.

(1) Be aware that such costs do not meet the criteria for allocability stated in FAR 31.201-4 (i.e., the costs are not incurred specifically for a government contract nor do they benefit government work).

(2) Make every effort to have the contractor segregate its expenditures to effect or resist a business combination as they are being incurred.

b. For contracts awarded on or after 4 April 1988, the costs incurred by a contractor in connection with successfully or unsuccessfully resisting a merger or takeover are expressly unallowable per FAR 31.205-27(a), and must be segregated as unallowable costs per FAR 31.201-6.

7-1708.2 Abnormal Executive Severance Pay (Golden Parachutes)

In order to discourage a hostile takeover attempt, some companies have instituted extraordinary arrangements with key employees to provide very large termination benefits to be paid only in the event of a merger or loss of control and the subsequent dismissal, termination, or departure of the executive. These arrangements have been referred to as "Golden Parachutes" because they provide extremely lucrative financial arrangements for the executives in those circumstances. See 7-1907.8 for a discussion of the allowability of these costs.

7-1708.3 Special Compensation for Retaining an Employee (Golden Handcuffs)

Special compensation which is contingent upon the employee remaining with the contractor for a specified period of time is commonly called "golden handcuffs," and is expressly unallowable per FAR 31.205-6(l), "Compensation incidental to business acquisitions." With respect to the FAR provision, it is important to note that the disallowance of costs is linked with the requirement for the employee to remain with the company. For example, assume an individual was performing a job normally paid and objectively worth \$50,000 per year, but for good reason, (e.g., to help the company through a rough financial period)

accepted and was paid only \$40,000 per year. If the new owners immediately raise the individual's salary to \$50,000, this would not be considered a "golden handcuff" unless the pay raise is granted on a condition that the individual would remain with the company for a specified period of time.

7-1709 References That Should Be Considered When a Major Change of a Contractor's Organization Structure Takes Place

- a. Access to Records CAM 1-504
- b. Advance Agreements FAR 31.109
- c. Asset Valuation Resulting from Business Combinations FAR 31.205-52
- d. Business Combinations APB 16
- e. Capital Investment CAM 5-602
- f. Capital Tangible Assets CAS 404
- g. CAS Disclosure Statement 48 CFR 9903.2
- h. Cash Disbursements CAM 14-306.2d
- i. CAS Impact Statement 48 CFR 9903.3
- j. Compensation FAR 31.205-6
- k. Consultants FAR 31.205-33 & 37.203
- l. Cost of Money FAR 31.205-10; CAS 414
- m. Depreciation FAR 31.205-11; CAS 409
- n. Economic Planning FAR 31.205-12
- o. Gains and Losses on Assets FAR 31.205-16
- p. Goodwill FAR 31.205-49
- q. Insurance FAR 31.205-19; CAS 416
- r. Intangible assets APB 17
- s. Labor Relations Costs FAR 31.205-21
- t. Pensions FAR 31.205-6(j); CAS 412 & 413
- u. Plant Rearrangement CAM 9-703.9
- v. Records Destroyed CAM 1-505
- w. Sale and Leaseback CAM 9-703.11
- x. SEC Current Report CAM 5-1S1 (Form 8k)
- y. Taxes FAR 31.205-41

7-1800 Section 18 — Joint Ventures, Teaming Arrangements, and Special Business Units (SBUs)**7-1801 Introduction**

a. This section provides guidance for audit evaluation of joint ventures, teaming arrangements, and special business units (SBUs).

b. The form of business organization chosen by the contractor to carry on its business or to bid on government contracts significantly affects contractor costs and income taxes. Eligibility for award of a government contract may be directly linked to the form of business organization under which a contractor elects to bid. Concurrently, the form of business organization will have a significant bearing on determining the allowability and allocability of costs incurred under government contracts. Therefore, in reviewing a contractor's business organization, the auditor must consider the related business circumstances and the contractor's compliance with generally accepted accounting principles, FAR, and CAS. An understanding of the applicable Internal Revenue Service Regulations and provisions of both Federal law and state law would also be beneficial in many instances.

7-1802 General Terms and Definitions

a. Corporation. A business organization of one or more persons, partnerships, associations, or corporations chartered by the state for the purpose of conducting profit making endeavors with the objective of dividing the gains. A corporation is a separate legal entity with the following usual characteristics: continuity of existence, centralized management, liability limited to corporate assets, and free transferability of interest. A corporation may perform any business action that can be performed by a natural person.

b. Joint Venture.

(1) An enterprise owned and operated by two or more businesses or individuals as a separate entity (not a subsidiary) for the mutual benefit of the members of the

group. Joint ventures possess the characteristics of joint control; e.g., joint property, joint liability for losses and expenses, and joint participation in profits. Joint ventures can be either incorporated or unincorporated. The incorporated joint venture involves the issuance of stock and is most common on large construction type contracts. These joint ventures possess the typical characteristics of a corporation. The unincorporated joint venture can be a partnership or teaming arrangement between two or more corporations usually involved in large research and development and/or major weapons systems contracts. Usually in this type of joint venture, the joint venture is the contracting entity and is designated to act as the prime contractor.

(2) Joint venture ownership seldom changes, and the stock of an incorporated joint venture is normally not traded publicly. Furthermore, under the usual arrangement: (a) each investor participates, directly or indirectly, in the overall management of the joint venture (i.e., joint venturers usually have an interest or relationship in the venture other than as passive investors); (b) significant influence of each of the investors is presumed to be present; and (c) one investor does not have control by direct or indirect ownership of a majority voting interest (otherwise the venture is likely to be a subsidiary of the controlling investor).

c. Teaming Arrangement. An arrangement between two or more companies, either as a partnership or joint venture, to perform on a specific contract. The team itself may be designated to act as the prime contractor; or one of the team members may be designated to act as the prime contractor, and the other member(s) designated to act as subcontractors. (See FAR Subpart 9.6.) When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the teaming arrangement is a joint venture. When these characteristics are not present then the

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arrangement may more closely resemble that of a prime contractor/subcontractor.

d. Partnership. An ordinary partnership occurs when two or more entities (persons) combine capital and/or services to carry on a business for profit. From a legal standpoint, it is a group of separate persons.

e. Cooperative Research Consortia. A cooperative research consortium is a partnership, joint venture, or corporation organized pursuant to the 1984 National Cooperative Research Act. Research consortia involve collaborations among competitors and are usually formed to explore specific research areas. Unlike other business entities discussed in this section, cooperative research consortia are not formed to bid on government contracts. See 7-1915 for additional guidance on cooperative research consortia.

f. Special Business Unit (SBU). SBU is the term used within CAM and other Agency guidance for those contractor business organizations established to (a) support a single contract, program, or product line, (b) limit financial, tax, or legal liability, and/or (c) gain a technical or cost advantage. For purposes of this guidance, SBU is used to refer to wholly-owned subsidiaries or divisions.

g. Subsidiary. An entity controlled, directly or indirectly, by another entity. Control is usually conditioned upon ownership of a majority of the outstanding voting stock. It may also exist, however, with less than a majority of the outstanding voting stock under certain conditions (e.g., there is a contract, lease, agreement with other stockholders, or court decree).

7-1803 Characteristics of Joint Ventures

a. An incorporated joint venture normally has characteristics common to a corporation (see 7-1802a.). It is a separate legal entity and acts as a contracting party.

b. An unincorporated joint venture usually is either a partnership or a teaming arrangement and most often has (1) few or no employees hired and paid by the joint venture, (2) little or no assets or separate facilities, (3) no separate finan-

cial statements, and (4) little or no G&A, B&P, or material handling expenses. All contract work is performed by the venturing organizations or other subcontractors. Employees are paid by their respective companies. The terms of the formation, operation, and dissolution of the venture are usually specified in a written agreement between the venturing organizations (see 7-1807a.).

7-1804 Characteristics of SBUs

a. Contractor wholly-owned subsidiaries or divisions can be legitimate contractor segments. These business organizations can have employees hired and paid by the SBU who actually perform the required contract effort. These business units can have their own assets and liabilities and have profit and loss responsibility. They are usually reportable segments for financial and tax purposes. These SBUs are often engaged in foreign military sales or direct commercial sales to foreign governments. The SBU is usually formed to limit tax and legal liability.

b. Other SBUs possess many of the same characteristics as joint ventures and teaming arrangements. These business organizations have no employees and subcontract virtually all (over 90 percent) contract effort to another contractor division and/or outside subcontractor(s). Often these SBUs have little or no assets. This type of SBU may have been formed to gain competitive, cost, and/or technical advantages.

c. Basically, there are two types of cost advantages that SBUs can attain. The first type results from the fact that an SBU is a specialized contracting entity supported by one or more established contractor entities. The second type results from the fact that an SBU contract can significantly reduce, or altogether avoid, the amount of material overhead and G&A that a prime contractor would normally have to allocate to its subcontracts and/or interdivisional work.

7-1805 Audit Considerations for Joint Ventures, Teaming Arrangements, and SBUs

a. This section presents guidance on the review of joint ventures, teaming

arrangements and SBUs. It discusses the implications of FAR, CAS and GAAP in reviewing the form of the business organization chosen by the contractor to propose and perform government contracts. Criteria for determining the actual relationship between the venturing organizations and the relationship between the SBU and the parent organization are also presented.

b. Headquarters has no knowledge of any existing incorporated joint ventures with significant auditable work. Therefore, the joint venture and teaming arrangement guidance in this section has been written to specifically cover unincorporated joint ventures, and may not apply to incorporated joint ventures.

c. There are a number of audit issues and concerns related to the formation, organization, and operation of joint ventures, teaming arrangements, and SBUs. These types of business organizations can have a material impact on the contractor's existing organizations and government business. The impact, however, is not always adverse, and the creation of joint ventures and SBUs may be proper and acceptable. A number of contractors have established joint ventures in response to an RFP requirement for contractor teaming arrangements. In these procurements it is the government's acquisition strategy to have two or more contractors team together to jointly design, develop, and test some type of new technology with the intent to qualify multiple contractor sources for future production. This type of acquisition strategy is most popular on major weapon system procurements. Normally, these teaming arrangements have the characteristics of joint and equal control where neither contractor possesses a majority ownership nor exercises management control. Similarly, some contractors have established wholly-owned subsidiaries or divisions for FMS contracting purposes. Many of these SBUs are legitimate business segments and may have been created to limit tax and legal liability.

d. There are also a number of joint ventures and SBUs that may not be legitimate business units and should be challenged. In developing audit steps to disclose and report on these situations,

consider both the form and substance of the business unit. In reviewing the form and substance of the business unit, consider the following:

(1) Is the joint venture or SBU considered a legitimate business segment? (see 7-1806.)

(2) What is the actual relationship between the venturing organizations? (see 7-1807.)

(3) Is the joint venture/SBU cost accounting and tax treatment consistent with the form and substance of the business organization? (see 7-1808 and 7-1809.)

(4) Does the joint venture/SBU accounting result in equitable cost allocations between and among the business organizations/segments? (see 7-1810.)

(5) Does the joint venture/SBU have a cost impact on the existing contracts of the venturing/parent organizations, and if so, has a change in cost accounting practice occurred? (see 7-1811.)

7-1806 Characteristics of A Legitimate Business Unit/Segment

a. When reviewing the accounting aspects of a contractor's business organization, the identification of the organization as a segment or business unit is important for the following reasons:

(1) CAS consistently uses the terms "segment" and "business unit" to present its accounting guidance on business organizations.

(2) Various financial accounting pronouncements, such as those dealing with consolidated reporting, also use the term "business segment" to present GAAP that applies to business organizations in general. (Note that the CAS and FASB definitions for "segment" are not exactly the same.)

(3) Joint ventures and SBUs that do not satisfy the basic criteria for a segment or business unit are often found to be in noncompliance with those provisions of CAS (e.g., 402, 403, 410, 418, and 420) which deal with the consistency and fragmentation of allocation bases. (See 7-1810.)

b. The terms "segment" and "business unit" are defined for CAS purposes in FAR 31.001. A CAS segment is "one of

two or more divisions, product departments, plants, or other subdivisions reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service." A CAS segment may include a GOCO facility, or a joint venture or subsidiary in which the organization exercises control. CAS does not define control nor provide criteria for determining whether an organization exercises control. A business unit, in turn, is any segment of an organization which is not further divided into segments.

c. Under GAAP (specifically APB Opinion No. 30, "Reporting the Results of Operations," and FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise"), the common characteristics of a segment are (1) separate product line; (2) profit/loss responsibility; (3) separate identification of assets, results of operations, and activities; and (4) full complement of general management and administration.

7-1807 Determining the Actual Relationship Between the Business Organizations

The form and substance of a contractor's business organization can significantly influence the allowability and allocability of costs incurred under government contracts. Determine not only the form of the business organization but the actual relationship (substance) between the venturing contractors. Several criteria and appropriate review procedures are presented below. Normally no one factor should be the sole determinant of whether the relationship is a joint venture or more closely resembles a prime contractor/subcontractor relationship. If the actual relationship more closely resembles that of a prime contractor/subcontractor then costs should be allocated consistent with this type of relationship.

a. Review of Joint Venture Agreements

(1) FAR 9.603 requires contractor joint ventures and teaming arrangements to identify and disclose the arrangements in an offer or, for arrangements entered into after submission of an offer, before the arrangement becomes effective. This is

normally done in a written agreement between the participating contractors. An agreement will normally contain and/or explain: (a) the name of the venture; (b) the customer and solicitation number; (c) the names of the participants; (d) any limitations on the powers and rights of the participants; (e) the contributions that each participant is required to make with regard to the venture's capital, personnel, proposal preparation, etc.; (f) anticipated subcontracts; (g) funding requirements; (h) responsibilities for record keeping and for the preparation of reports and invoices; (i) the designated management; (j) limitation of liabilities; (k) term of venture and dissolution agreements; (l) responsibilities for and restrictions on royalties, patents, copyrights, and property rights arising from venture operations; (m) the resolution of disputes among the venturers; (n) covenants on how litigation costs will be borne by the participants; (o) which state's laws will govern the venture; and (p) the filings or disclosures required by the state, FAR, etc; (q) any technology transfer agreements; and (r) any cost/profit sharing agreements.

(2) Review the written agreement to help determine the management, financial, and technical responsibilities of each contractor. In addition, review the joint venture/teaming arrangement organization chart(s) and policies and procedures. This information can be useful in determining if the characteristics of joint control and management are present or if one contractor seems to possess the control and management characteristics of a prime contractor.

b. Ascertain each venturer's responsibility for the financial and technical management of the joint venture. Determine the composition of the joint venture management team, the location of the joint venture program office, the procedures for preparing the joint venture financial statements, tax returns, and government billings and technical reports. Also review each venturer's responsibility and role in the preparation of the joint venture proposal. Ascertain each venturer's responsibilities for outside subcontractor selection and material purchasing. The composition of the key

personnel to the joint venture should also be analyzed. When considered together this information will help determine the actual relationship between the venturers. It will also help determine if one venturer exercises control over the joint venture.

c. Review the composition of the joint venture or teaming arrangement capital and equity to help determine if one of the venturers exercises ownership control. Analyze any cost and revenue sharing agreements and asset contributions.

d. Review the technical relationship between the venturers by reviewing the written agreement, any technical exchange agreements, the cost and technical proposals, the contract and/or subcontract statements of work, and other relevant documentation. Determine the assignment of technical responsibilities to each venturer, the integration of work products between the venturers, and the technical areas of expertise of each venturer. The responsibilities of each organization for technical interface with the government can also help determine the technical relationship between the venturers.

e. Discuss the joint venture/teaming arrangement with the cognizant DCAA offices for the other venturing contractors to help ensure consistent audit treatment. Coordinate with the other cognizant DCAA offices to establish responsibilities for audits of forward pricing proposals, public vouchers, progress payments, etc., to request appropriate assist audits, and to ensure adequate audit coverage of joint venture costs. See 6-800 and 9-100 for additional guidance on audit coordination between DCAA offices and for requesting assist audits.

7-1808 Accounting Considerations for Joint Ventures, Teaming Arrangements, and SBUs

7-1808.1 Accounting Considerations for Joint Ventures

a. General. A joint venture, proposed and established as a separate business entity, should have its own set of books and supporting documentation sufficient for an audit trail. Transactions should be

recorded consistent with the joint venture agreement (7-1807a.), and care must be taken to ensure that the joint venture bears its equitable share of the costs. For audit guidance on the general implications of FAR, CAS, and GAAP in the review of joint ventures and SBUs, see 7-1810.

b. Incorporated Joint Ventures. Investors, in most circumstances, should use the equity method to account for incorporated joint ventures. The generally accepted accounting principles (GAAP) relating to this method of accounting for investments in joint ventures are contained in APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," and, to a lesser extent, in APB Opinion No. 23, "Accounting for Income Taxes-Special Areas." Paragraph 16 of APB 18 concludes that investments in common stock of incorporated joint ventures should be accounted for by the equity method, regardless of the percentage of stock held, to reflect the underlying nature of their investment in such ventures. The uncommon circumstances under which the cost method of accounting for incorporated joint ventures should be used in lieu of the equity method are noted in paragraph 16 of APB Opinion No. 18.

c. Unincorporated Joint Ventures. The provisions of APB Opinion No. 18 have generally been interpreted as being applicable to unincorporated joint ventures as well as incorporated joint ventures. Therefore, in most circumstances when the investment in an unincorporated joint venture is material, the equity method should also be used to account for the investment.

d. Joint Venture Accounting as a Partnership. If a joint venture elects to be treated as a partnership, or is required by either the Federal tax code or any state's partnership laws to be treated as a partnership, then the joint venture should (1) adopt accounting practices that are consistent with the single entity concept, and (2) maintain a complete set of books and records.

e. See 7-1807 for criteria to help determine the actual relationship between the venturing contractors.

7-1808.2 Accounting Considerations for Teaming Arrangements

a. The accounting for teaming arrangements should be consistent with the form of business organization that the teaming contractors have agreed to and disclosed in their proposal(s). For example, if the agreed-to arrangement is in the form of a joint venture, then this should be disclosed in the proposal(s) and the accounting principles applicable to a joint venture should be followed. FAR 9.603 requires contractors to fully disclose all teaming arrangements in their offers. If an arrangement is entered into after submitting an offer, then disclosure is required before the arrangement becomes effective.

b. When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the business arrangement is a joint venture. If the characteristics of joint control are not evident, then the terms of the business arrangement should be reviewed to see if a prime contractor/subcontractor relationship exists between the parties. Note, however, that a disclaimer of a joint venture arrangement in itself does not preclude an arrangement from being classified as a joint venture if it possesses the characteristics of a joint venture. See 7-1807 for criteria to determine the actual relationship between the contractor organizations.

7-1808.3 Accounting Considerations for SBUs

A Special Business Unit or SBU, as explained in 7-1802f., is DCAA's term to describe a contractor subsidiary, division, or other form of business organization established to accomplish certain specific tasks or to gain a competitive advantage. It is not a distinct entity form; therefore, the accounting for an SBU should follow the principles established for the actual entity involved and be consistent with the contractor's disclosed accounting practices.

7-1809 Federal Income Tax Considerations

7-1809.1 Tax Classification and Definitions of Organizations

a. General. The classification and definitions of organizations for Federal tax

purposes are contained in the regulations of the Internal Revenue Service (26 CFR 301.7701-1 et seq.). Except for organizations of professional persons, local law will have little bearing in the determination of an entity's classification for tax purposes. The tax and common business law definitions for the various types of business organizations are usually different. Some examples of these differences are noted below.

b. Corporation. The term "corporation" as defined in the CFR is not limited to the entity commonly known as a corporation (see 7-1802a.); it includes an association, a trust classified as an association due to the nature of its activities, a joint-stock company, an insurance company, and certain kinds of partnerships.

c. Partnership.

(1) The term "partnership" is also broadly defined in the CFR to encompass just about all types of unincorporated organizations including most forms of syndicates, groups, pools, and joint ventures. In other words, if a legal business entity does not constitute a trust, estate, or corporation for tax purposes, then it is likely to be considered a partnership. Further note that the tax status of a partnership is not affected by the fact that a corporation may be one of the partners, or that local law does not permit a corporation to be a partner.

(2) Notwithstanding the above, DoD contractors have established several forms of unincorporated joint ventures and joint venture teaming arrangements that they do not consider to be partnerships for tax purposes.

d. Limited Partnership. A limited partnership, depending upon its specific characteristics, is classified in the CFR as either an ordinary partnership or as an association taxable as a corporation.

e. Association. Section 301.7701-2 of the CFR defines an association as a corporation if it has certain characteristics, including: (1) associates, (2) free transferability of interest, (3) an objective of carrying on a business and distributing profits, (4) liability for debt limited to corporate property, (5) continuity of life (i.e., a going concern), and (6) central management.

7-1809.2 Review of Tax Returns

a. Review the joint venture, teaming arrangement, or SBU tax returns and supporting records to determine, confirm, or gain additional insight into the type and nature of the contracting entity. Tax information can answer questions on ownership and control and on whether a given organization exists as a separate legal business entity or as a component of a contractor's existing business entity. When reviewing a joint venture or teaming arrangement that may or should be treated as a partnership for tax purposes, request Schedules K and K-1, supporting Partnership Return Form 1065. These schedules address the apportionment of income, credits, deductions, etc. to the individual partners (i.e., joint venturers/team members). They also identify the individual partners and contain other information relating to the assessment of costs, degree of control, ownership of capital, percentages of profit and loss sharing, and credits.

b. General guidance on the review of contractor tax returns is provided in 5-109, and brief descriptions of some of the applicable tax forms are presented in 5-152.

7-1810 FAR and CAS Considerations for Joint Ventures, Teaming Arrangements, and SBUs**7-1810.1 FAR Compliance**

a. General. The FAR does not specifically address a joint venture as a party in the procurement of supplies and services under government contracts. It is therefore necessary to understand the purpose for and characteristics of a joint venture when reviewing the venture in terms of the FAR, specifically the FAR cost principles on allowable costs.

b. Material/Service Costs and Venture Control. When one of the venture participants exercises majority control over the joint venture, FAR 31.205-26(e) specifically provides that the transfer of material costs or service costs from any of that company's segments to the joint venture should be on the basis of cost incurred, unless competitive or catalog prices are involved. In the event that the venture

members appear to be equal participants, the provisions of FAR 31.205-26(e) still apply, if the auditor can determine that one of the members actually exercises predominant control over the venture. To help make this determination the auditor should look at the venture agreements to ascertain if any member has significant risk or underwriting responsibility in disproportion to the others.

7-1810.2 CAS Compliance**a. CAS Disclosure Statements.**

(1) General. Any defense contractor which, together with its segments, receives awards of CAS-covered negotiated national defense contracts totaling more than \$10 million in its most recent cost accounting period must submit a CAS Disclosure Statement (48 CFR 9903.202-1(b)). Furthermore, any business unit that is selected to receive a CAS-covered negotiated national defense contract or subcontract of \$10 million or more is also required to submit a Disclosure Statement.

(2) Joint ventures are composed of two or more contractors each of which may have already filed a Disclosure Statement as a result of having obtained other government contracts. Review the characteristics of the joint venture to determine if the joint venture meets the definition of a CAS segment.

(3) The need for a joint venture CAS Disclosure Statement depends upon the characteristics of the venture itself. The determination must be made on a case-by-case basis. Where the joint venture is the entity actually performing the contract, has the responsibility for profit and/or producing a product or service, and has certain characteristics of ownership or control, a Disclosure Statement should be required. Where the venture merely unites the efforts of two contractors performing separate and distinct portions of the contract with little or no technical interface, separate joint venture disclosure may not be required. Where doubt exists, discuss the circumstances with the contracting officer.

b. CAS covered contractors that have established joint ventures or SBUs which satisfy the basic criteria for a segment or business unit are usually found to be in

compliance with those provisions of CAS which deal with the consistency and fragmentation of allocation bases. Conversely, contractors with joint ventures or SBUs which do not satisfy the basic criteria for a segment or business unit are often found to be in noncompliance with CAS. Further background on the most frequently cited areas of noncompliance is provided below.

c. CAS 403 and the Allocation of Home Office Expenses.

(1) General. Most of the joint ventures or teaming arrangements encountered to date have been established as CAS 403 segments with the venturing companies acting as intermediate home offices for their share of the venture costs. Such arrangements usually involve the adoption of a "special" method of allocating residual home office expenses wherein each venturer allocates a portion of its residual expenses to their portion of the joint venture costs. Notwithstanding this background on the typical arrangement, follow the guidance below in the review of home office expenses relative to joint ventures.

(2) If the joint venture or teaming arrangement is considered a segment in accordance with the definition of CAS 403 (see a & b above), the auditor needs to ensure that each of the venturing companies (a) identifies and directly allocates those home office expenses that were specifically incurred in support of the joint venture, (b) separately allocates to the joint venture its share of home office support expenses from any homogeneous pools, and (c) adopts one of the following practices for the allocation of residual expenses:

(a) The venturers can request a special allocation of the residual expenses in accordance with the criteria in CAS 403.50(d)(1).

(b) The majority or controlling contractor can treat the joint venture as a segment of its company, and include the entire operations of the venture in its formula for allocating residual expenses.

(c) The minority contractor may also allocate its company's residual expenses to joint venture, but is not required to.

(3) The joint ventures and teaming arrangements that have not been formed

as separate CAS 403 segments (see a & b above) generally do not have, and would not be expected to have, significant assets or payrolls (elements of the three factor formula for allocating residual expenses). Home office expenses are allocated to the contracts of these joint ventures in the same manner that the venturing companies allocate these expenses to their other contract work.

d. CAS 410.50(d) requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. Only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense can the contractor deviate from this requirement. All special allocations of this nature must be handled in accordance with CAS 410.50(j). Such special allocations may be appropriate in unusual circumstances that are not expected to recur. To the extent that subcontracts or any other significant element of cost input, representative of the total activity of the unit, are excluded from the base, a noncompliance occurs.

e. CAS 420.50(f)(2) requires that the cost input base used to allocate IR&D/B&P costs to all final cost objectives be the same as the G&A allocation base. As with G&A above: (a) only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from IR&D/B&P costs can the contractor deviate from this requirement, and (b) to the extent that a significant element of cost input is excluded from the base, a noncompliance occurs.

f. CAS 418.50(d)(2) states that a material cost base is appropriate if the activity being managed or supervised is a material-related activity. Upon selection of a material cost base, all significant elements shall be included in that allocation base.

g. When reviewing joint ventures or teaming arrangements that have been established as a separate business entity and which have a CAS-covered contract the auditor should:

(1) Treat the venture as a separate contractor segment, even if the venture has few, if any, assets or employees, and no up-front investment. See 7-1806 for further guidance relating to the determination of separate business units/segments.

(2) Ensure that all of the costs that should be allocated to the venture are appropriately allocated to the venture in accordance with the provisions of CAS. (G&A and IR&D/B&P, for example, should be allocated to the venture according to the provisions of CAS 403, 410, and 420.)

h. When reviewing joint ventures and teaming arrangements that have not been established as a separate business entity, the auditor should:

(1) Determine the reasons why the venture is not being treated as a separate entity or CAS business unit/segment. For example, do the venturers claim that a separate segment does not exist because (a) the venture has no assets, employees, or up-front investment, and/or (b) the cost impact of establishing the venture as a separate entity is not significant enough considering the extra administrative costs involved?

(2) Determine how the venture and venturing companies are being treated and accounted for. For example, are the venturing companies being treated as independent contractors (vs. subcontractors to the joint venture)?

(3) Develop a position based on appropriate consideration of (a) the CAS requirements, (b) the principle of "substance over form," (c) materiality of the cost impact associated with establishing a separate entity, and (d) the intent of the contracting officer. If a preliminary position is developed which substantially differs from, or conflicts with, the intent of the contracting officer, elevate this matter through normal channels to the attention of the Headquarters Accounting Policy Division.

(4) Meet with the contracting officer and/or administrative contracting officer to (a) discuss your findings and the contracting officer's position with respect to the arrangement, and (b) work toward changing any unsuitably proposed or established joint ventures.

(5) Communicate any adverse impact associated with the joint venture arrangement (i.e., CAS noncompliance or accounting inconsistency) to the ACO, cognizant PCO, and other PCOs affected by the arrangement, and continue to closely monitor the arrangement for such an impact.

7-1811 Changes in Cost Accounting Practices

a. Basic Audit Requirement. Once a CAS-covered joint venture or SBU is determined to be a legitimate business unit, and there are no apparent CAS noncompliances associated with the allocation of costs, the auditor must next determine whether the SBU organization itself has impacted the costs on any existing company contracts, and if so, whether a change in cost accounting practice occurred. Each organizational change must be evaluated separately to determine whether a change in cost accounting practice has occurred. Specific criteria for making these determinations are provided in 48 CFR 9903.302 and CAM Chapter 8, and are restated in part below.

b. Basis for Audit Determination.

(1) The CAS definition for a change in cost accounting practice is presented in 48 CFR 9903.302-2. The CAS Board's discussion on when an organizational change may be considered a change in cost accounting practice is presented in Part II, Preamble J, of the Appendix to FAR loose-leaf edition. As part of this discussion, the Board stated that while organizational changes by themselves are not changes in cost accounting practices, such changes may cause a change in a contractor's cost accounting practices. The Board further stated that the decision as to whether there is a change in cost accounting practice should be made through an analysis of the circumstances of each individual situation based on the criteria being promulgated in the CAS regulations.

(2) Any organizational change which separates (or consolidates) business units' indirect pools or bases, and which results in an alteration in the composition of the pools or bases: (a) represents a change in

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cost accounting practice, and (b) requires an adjustment to CAS covered contracts for any increased costs per the CAS clause (FAR 52.230-2).

c. References For Pursuing Cost Accounting Changes. The CAS rules, regulations, and administrative requirements for changes in cost accounting practices are contained in 48 CFR 9903.3 FAR 30.602, and CAS contract clause FAR 52.230-5, "Administration of Cost Accounting Standards." CAM addresses accounting changes in 8-303.3 and 8-500.

d. Evaluating Cost Impact. When reviewing a joint venture or SBU to determine the cost impact on existing company(s) contracts, care must be taken to distinguish between (1) the cost impact due to the change in the composition of the pool and base and (2) the impact due to the initial adoption of a cost accounting practice, or the partial or total elimination of a cost or the cost of a function, which are not considered changes in cost accounting practices under CASB rules and regulations.

7-1900 Section 19 — Other Areas of Cost**7-1901 Introduction**

This section covers other areas of cost not requiring a full section coverage at this time.

7-1902 Personnel Procured From Outside Sources

Some contractors have adopted the practice of obtaining engineers, technical writers, technicians, craftsmen, and other personnel by subcontract (commonly called "Purchased Labor") rather than by direct hire. Such practice, if for any reason other than to meet temporary or emergency requirements, should be carefully studied to determine whether any additional costs resulting therefrom are reasonable, necessary, and properly allocable to government contracts.

7-1902.1 Audit Considerations

- a. The accounting treatment of purchased labor varies depending on the circumstances under which purchased labor costs are incurred.
- b. Purchased labor most likely causes no fringe benefits and other employee-related costs to be incurred by the contractor. Such costs are generally paid by the entity providing personnel performing the effort.
- c. A fundamental requirement of CAS 418 is that pooled costs shall be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed accounting practices. In accordance with CAS 418, a separate allocation base for purchased labor may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs, or to eliminate other costs not benefiting purchased labor such as fringe benefits costs.
- d. Where the effort of purchased labor is performed in-house using the contrac-

tor's supervision and facilities, overhead exclusive of fringe benefits and other employee related costs, if material in amount, should be allocated to purchased labor. Conversely, where the effort of purchased labor is performed off-site under the supervision and control of an entity other than the contractor, none of the contractor's labor overhead costs may be allocable to purchased labor.

7-1902.2 Audit Procedures

The accounting treatment for purchased labor must be evaluated on a case-by-case basis with consideration given to the materiality of costs involved and the overall effect of the accounting treatment on final cost objectives. Acceptance or rejection of the contractor's treatment of purchased labor must be based upon (1) the causal and beneficial relationship of indirect expenses and purchased labor, and (2) the nature of the employer/consultant relationship using the Internal Revenue Services arms-length tests. In making this assessment, the auditor should:

- a. Review the contractor's policy, with emphasis on the criteria used in determining whether personnel should be obtained from outside sources instead of by direct hire.
- b. Analyze the purchased labor during the current or most recently completed fiscal year, whichever provides sufficient information, to:
 - (1) Determine the number of purchased labor personnel and the duration of their engagement.
 - (2) Compare the number of employees on the contractor's payroll (in each classification of purchased labor involved) with the number of equivalent personnel obtained from outside sources.
 - (3) Compare the cost per staff-year with the contractor's comparable personnel.
 - (4) Evaluate the contractor's reasons for resorting to the practice. This is particularly important where the engagement extends beyond one year.
 - (5) Determine whether the contractor's practices are equitable with respect to the

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utilization of purchased labor on government contracts as compared to commercial work, and on fixed-price contracts as compared to cost-type contracts; and whether the accounting treatments of the costs of such personnel and contractor personnel performing the same kind of work, including allocation of related overhead expenses, are equitable.

c. Coordinate with government production specialists, project engineers, purchase methods analysts, and others on matters such as the effectiveness of performance, staffing requirements, equivalent job classifications, and the award and pricing of the agreements.

d. Examine prior years' records to determine if the practice shows an increasing or decreasing trend.

7-1903 Employee Welfare and Morale Expense

Employee welfare and morale expenses are costs incurred on activities to improve working conditions, employer-employee relations, employee morale, and employee performance. Expenses and income generated by employee welfare and morale activities should be reviewed for compliance with FAR 31.205-13.

7-1903.1 Audit Considerations**a. General**

(1) Aggregate costs incurred for employee welfare and morale, less credits for income generated by these activities, are allowable except as noted in paragraphs c. and d. below, to the extent that the net amount is reasonable.

(2) Costs relating to welfare and morale activities, e.g., company parties, banquets, plant-wide picnics or outings, publications intended for communicating with employees, etc., if significant, should be subjected to the test of reasonableness as to purpose and amount (also see 7-1203.2a). When reasonableness as to purpose has been established, reasonableness of amount should ordinarily be applied to overall amounts and not to individual items of cost, provided the items are not specifically unallowable by FAR Part 31. Where restaurant or other employee services are furnished by a concessionaire, the auditor should review

the agreement with the concessionaire and determine whether the contractor effectively monitors the operation.

b. Employee Associations

(1) If a contractor has an arrangement permitting an employee association to retain the income from vending machines, such income should be considered in evaluating the total cost of the employee welfare and morale program as if the contractor received the income (FAR 31.205-13(c) and (d)). The auditor should examine the records of the employee association to ascertain that the income was reasonably expended for the purposes intended and that there is no undue accumulation of unspent funds. Any such accumulation should accrue to the government by treating it as a deduction from otherwise allowable overhead.

(2) In some instances, employee associations may use the vending machine income for the purchase of recreational and other employee welfare tangible personal or real property, or the employee association may purchase assets by means of a loan or mortgage. Allowable costs on capital assets thus purchased are limited to the equivalent amount of costs that would be allowable if the contractor had acquired the property and incurred the costs directly (FAR 31.205-13(d)). Accordingly, allowable costs will normally be restricted to ownership costs such as depreciation, insurance, taxes, etc. The total expenditure for property should not be allowed as a cost in the year of purchase, except where the property involved is of the type that would be expensed under the contractor's normal accounting practices.

c. Major Property Acquisitions for Employee Welfare Purposes

The reasonableness of major property acquisitions for employee welfare purposes is necessarily a matter of some significance. The auditor should review such purchases to determine whether (1) they are reasonable under the criteria set forth in FAR 31.201-3 and (2) costs resulting therefrom are properly allocable to government contracts. If the assets acquired are not of a type generally recognized as ordinary and necessary for purposes of employee welfare and morale, the related costs may be considered

unreasonable and, therefore, not acceptable. A situation fitting this category would be when the acquisition benefits only a limited number, or certain classes, of employees. As a further consideration, real property donated or acquired from contributions made by the contractor should be carefully scrutinized, as it would seldom be reasonable for the contractor to give the property to its employee organization. Doing so would not as a rule give the employee association any benefit from the use of the property that it would not enjoy had the contractor retained title. By retaining title the contractor would keep a valuable asset which could be converted to other use or sold when it is no longer needed for its original purpose.

d. Cafeteria Losses

(1) The costs of cafeteria operations should include all indirect expenses pertaining to these services, as required by the full absorption cost methods prescribed by CAS 418. Auditors will verify that an allocable share of occupancy costs are included in the calculation of the total costs of cafeteria operations.

(2) Losses from operating cafeterias may be included as costs only if the contractor's objective is to operate such services on a break-even basis. One factor to consider is whether the prices charged are comparable to those available in commercial establishments. Losses sustained because these services are furnished without charge or at unreasonably low prices obviously would not be conducive to the accomplishment of the above objective and are not allowable. However, a loss may be allowable, provided the contractor can demonstrate that unusual circumstances exist such that even with efficient management, operating the service on a break-even basis would require charging inordinately high prices, or prices higher than those charged by commercial establishments. Examples of unusual circumstances are: (1) adequate commercial facilities are not available, or (2) reasonable prices are a necessary incentive to keep employees on site to avoid the more significant costs of lost productive time due to longer lunch periods if the services were not provided.

(3) When cafeteria losses are claimed by the contractor, it is the contractor's responsibility to demonstrate that unusual circumstances exist and to provide supporting documentation such as price comparisons with similar commercial establishments, or the distance of restaurants. The auditor should determine the validity of the contractor's justifications on a case-by-case basis. If the contractor fails to provide adequate documentation justifying the allowability of such losses, the auditor should question the costs.

7-1904 Help Wanted Advertising Costs

By provision of FAR 31.205-1 (Public Relations and Advertising Costs), help wanted advertising costs are allowable provided they are for recruitment of personnel for the performance of contract obligations. Help wanted advertising costs are often incurred for common or joint objectives so that the specific amount applicable to each is not identifiable. FAR 31.205-1(d) provides that costs of this nature, if incurred for more than one government contract or for both government work and other work of the contractor, are allowable to the extent that the principles in FAR 31.201-3 (Determining Reasonableness), FAR 31.201-4 (Determining Allocability), and FAR 31.203 (Indirect Costs) are observed. Also see CAM 6-407.

7-1904.1 Audit Considerations

a. Paragraph (b) of FAR 31.205-34 (Recruitment Costs) lists several conditions, the presence of any one of which causes the costs of the entire advertisement to be unallowable. These conditions and related audit considerations follow:

(1) FAR 31.205-34(b)(1) states that advertisement for personnel other than those required to perform obligations under a government contract is unallowable. However, FAR 31.201-1 (Composition of Total Cost) states that the total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract. Therefore, this provision should not be interpreted so as to prohibit the allowance of help wanted advertising costs applicable to indirect

7-1904.1a.

employees, such as accountants, internal auditors, lawyers, etc. This provision does, however, prohibit the allowance of help wanted advertising costs that are for personnel peculiar to the performance of obligations under commercial contracts.

(2) Help wanted advertising which does not describe specific positions or classes of positions is unallowable. For example, advertising which is aimed at building a backlog of resumes, rather than at filling specific job openings would fall under the unallowable category. Review of the contractor's help wanted advertisement and replies to applicants should help to determine whether or not the advertisement is one for filling specific job openings. When the contractor is observed to be expanding its current work force, an audit lead should be developed and pursued in a subsequent audit to determine whether the contractor's projected base used for estimating overhead rates considers such expansion.

(3) Advertising which is excessive in relation to the number and importance of the positions, or in relation to the practices of the industry, is unallowable. Inherent in any such determination is not only the size of a particular advertisement in a publication, but also the length and frequency of recruitment advertising in all media (including radio and television). Consideration must also be given to the effectiveness of the advertising program in terms of responses by qualified personnel and the number of hires. This is an area in which technical assistance from the administrative contracting officer can be most useful.

(4) Help wanted advertising which includes material that is not relevant for recruitment purposes, such as extensive illustrations or descriptions of the company's products or capabilities, is unallowable. Conversely, allowable recruitment advertising should be limited to information such as:

- (a) Description of the position(s) being offered.
- (b) Description of the compensation and fringe benefits.
- (c) Qualifications of the applicant(s).
- (d) Opportunities for advancement.
- (e) Brief description of the company and its work.

(f) Pertinent illustrations, conservative in size, that do not evidence promotion of the sale of the contractor's products or fostering of its image.

(g) Name of the company, conservatively presented in relation to the other information in the advertisement.

(h) Help wanted advertising (in publications) which includes color (other than black and white) is unallowable.

(i) Recruitment advertising designed to "pirate" personnel from another government contractor is unallowable. Falling into this category would be advertising that specifically offers excessive fringe benefits or salaries significantly in excess of those generally paid in the industry for the skills involved. Usually, advertising of this nature would also contain features which would render it unallowable within one or more of the other limitations noted above.

b. By reason of the several restrictions placed on their allowability, help wanted advertising costs become a sensitive audit area. Accordingly, the auditor should review any corollary help wanted advertising costs as well as the costs of the advertising media themselves. The costs of photographs, art and design work, radio and television tapes, whether purchased or incurred in-house, are examples of corollary advertising costs.

7-1905 Professional and Consultant Service Costs

Professional and consultant fees represent costs of services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Such costs include those of outside accountants, lawyers, actuaries, and marketing consultants. Contractors should be requested to obtain billings from outside professionals and consultants which itemize amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, travel, and miscellaneous expenses.

7-1905.1 General Considerations on Outside Professional and Consultant Services

- a. The cost principle covering outside professional and consultant services is

contained primarily in FAR 31.205-33, Professional and Consultant Service Costs. These costs are allowable when reasonable in relation to the services rendered and when not contingent upon recovery from the government, except for expressly unallowable costs noted in 7-1905.3 (but see 7-1918 for costs associated with a legal or administrative proceeding).

b. Some factors to be considered in determining the allowability of costs are listed in FAR 31.205-33(f).

c. Contractors may engage outside professionals and consultants on a retainer-fee basis. Retainer fees must be supported by evidence that: (1) the services covered are necessary and customary, (2) the fee is reasonable in comparison with maintaining an in-house capability, and (3) the level of past services justifies the amount of the retainer fees.

d. The auditor should assess the risk that there are irregularities associated with consultant costs. For example, attempts to conceal unallowable political donations or bribes by classifying them as consultant fees.

7-1905.2 Adequacy of Supporting Evidential Matter

a. For contracts entered into on or after 7 March 1990, fees for actual services performed (including retainer fees) must be supported by the following specific supporting evidential matter:

(1) Details of all agreements (e.g. work requirements, rate of compensation, and nature and amount of other expenses if any) and details of actual services performed.

(2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.

(3) Consultant work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

b. While the applicable FAR cost principle prior to 7 March 1990 did not identify specific documentation required to support claimed cost, it did contain a general evidentiary requirement (except for retainer fees) that claimed cost must

be supported by adequate evidence of the nature and scope of services furnished. Most, if not all, of the specific supporting evidence now detailed in the FAR cost principle would be critical in meeting this general evidentiary requirement. In determining the adequacy of supporting evidential matter, the auditor should obtain (1) sufficient, (2) competent, and (3) relevant evidence to afford a reasonable basis for the auditor's judgements and conclusions.

(1) Determining the sufficiency of evidence requires the auditor to use judgment in assessing the type and extent of evidence necessary to corroborate the consultant or professional agreement. Such corroborating evidence may include statements of actual work, invoices, work products, trip reports, meeting minutes, collateral memorandums, or evidence of other company actions taken in response to the professional or consultant's effort. For example, if there is no work product, then the auditor would require evidence such as statements of actual work, invoices, and/or professional or consultant agreements. However, if a work product does exist, an invoice alone may be sufficient.

(2) In evaluating the competence of evidence, the auditor should carefully consider whether reasons exist to doubt its validity or completeness. If so, the auditor should obtain additional evidence or reflect the situation in the report. For example, if the contractor has prepared a professional's or consultant's statement of work on an after-the-fact basis, then the auditor will require additional evidential matter. Similarly, if no work product exists, the auditor will require some form of third party verification, e.g., a statement from the professional or consultant, or the contracting officer.

(3) The information used to prove or disprove an issue is relevant if it has a logical, sensible relationship to that issue. Information that does not is irrelevant and therefore should not be included as evidence. For example, if no work product exists, the auditor will require some form of relevant evidence. In such a case, the presence of a written professional or consultant agreement that expired two

7-1905.2b.

years ago will bear little or no relationship to the current-year professional and consultant costs, and is therefore not relevant evidence. On the other hand, a statement of actual work from the professional or consultant will be relevant evidential matter.

c. It is the contractor's responsibility to produce adequate evidential matter to support the claimed costs. If the auditor determines that the claimed costs require additional support, then he or she should notify the contractor as to the additional data required. The auditor should provide the contractor with a reasonable period of time to respond. If the contractor fails to respond within this period, the costs should be disallowed. The auditor should not attempt to obtain the additional data by requesting attorneys, consultants, or government personnel to prepare statements of work.

7-1905.3 Allowability of Costs and Audit Considerations

a. Professional and consultant costs are subject to the general criteria of reasonableness and allocability in FAR 31.201-3 and 31.201-4. Costs related to legal and other proceedings are also governed by FAR 31.205-47. The following costs are designated as unallowable in accordance with the FAR provisions as referenced:

(1) Costs contingent upon recovery from the government (FAR 31.205-33(b)).

(2) Services to improperly obtain, distribute, or use information or data protected by law or regulation (FAR 31.205-33(c)(1)).

(3) Services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award (FAR 31.205-33(c)(2)).

(4) Any services performed or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest (FAR 31.205-33(c)(3)).

(5) Services performed which are not consistent with the purpose and scope of the services contracted for or agreed to (FAR 31.205-33(c)(4)).

(6) Costs of organization and reorganization (FAR 31.205-27).

(7) Costs of raising capital, financing and refinancing operations, preparation of prospectuses, and preparation and issuance of stock rights (FAR 31.205-20 and FAR 31.205-27(a)).

(8) Costs related to bad debts (FAR 31.205-3).

b. Costs incurred by employees or officers of the contractor for purposes which are similar to those classified as unallowable by FAR 31.205-33 are also unallowable even though that cost principle specifically applies to outside professionals and consultants. FAR 31.204(c) provides that the failure to include any item of cost does not imply that it is either allowable or unallowable. This determination is to be based on the overall principles and standards set forth in the FAR and the treatment of similar or related selected items. Under that rule, if a cost is unallowable if incurred by the performance of an outside service, then the cost of similar work performed in-house is also to be considered unallowable.

7-1906 Capital Items as Contract Costs

a. Contractors sometime include the unamortized value of capital equipment in contract cost presentations. For items other than approved special tooling, machinery, or equipment, and in the absence of specific contractual coverage, the auditor will question costs of capital items (See also FAR Part 45).

b. Special Tooling and Special Test Equipment. The cost of special tooling and special test equipment (as defined in FAR 45.101a) used in performing one or more government contracts is allowable and shall be allocated to the specific government contract or contracts for which acquired (FAR 31.205-40). In auditing costs for special tooling or test equipment, determine if such items are properly classified and authorized under the contract. (See FAR 45.306, Special Tooling and FAR 45.307, Special Test Equipment). Unauthorized or otherwise inappropriate charges for this type of item may be misclassified in detailed cost accumulations such as for material, supplies, or miscellaneous in-house work

orders for fabrication, production support, or maintenance (see 9-602). The auditor will use the government property administrator's review data and evaluation reports, and should request technical assistance to review any observed or suspected deficiencies (See 14-400).

c. For all new DoD contracts awarded on or after 16 January 1987, the interim rule issued under DoD FAR Supplement (DFARS) 215.871 requires that: (1) A contract shall not provide for payment as a direct cost of more than 50 percent of the full acquisition cost of Production Special Tooling/Production Special Test Equipment (PST/PSTE) when the purchase of additional quantities of like items is contemplated in subsequent years, (2) The deferred cost of PST/PSTE shall not be shifted or assigned to other programs by charging such costs to indirect cost pools, and (3) Special provisions are to be considered for inclusion in solicitations and contracts which apply to PST/PSTE. Auditors should evaluate forward pricing proposals, forward pricing rates, public vouchers and progress payments for compliance with this provision.

7-1907 Employee Termination Payments

7-1907.1 Termination Plans, Early Retirement Incentives, and Severance Payments

a. A termination plan sets out the criteria used by a contractor to terminate its employees and determines the termination compensation to be paid to those employees.

b. A special termination plan uses different criteria than the contractor's normal established criteria or provides different benefits than its normal established benefits. Special termination plans are used for unusual circumstances such as the requirement to make mass terminations or a goal to make significant reductions in the company's work force. In such situations, employers have found it advantageous to provide incentives for employees who "volunteer" to be terminated. The employer can design these plans to limit the employees eligible for

termination as well as steer employees who would be the best choices from the employer's viewpoint toward "volunteering."

c. Early retirement incentive payments are payments made pursuant to a plan offered exclusively to employees eligible to retire under a pension plan. The purpose of such plans is to induce eligible employees to make an election to retire early and receive immediate pension benefits. Early retirement incentives are sometimes included within a termination plan. If included in a termination plan, the early retirement incentive policy and procedures must meet the same requirements as if it were a separate plan. (For further discussion of early retirement incentive payments, see 7-608.) FAR 31.205-6(j)(7) limits the allowable amount of the early retirement incentive payment to the employee's annual salary for the last contractor fiscal year completed prior to the employee's retirement.

d. Severance pay, also commonly referred to as dismissal wages, is defined in FAR 31.205-6(g) as a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. If a contractor makes a severance pay plan available to its employees regardless of their retirement eligibility, the payments from that severance plan are allowable if they are reasonable and in accordance with FAR 31.205-6(g). The payments made under a severance pay plan to employees who, coincidentally, are also eligible for pension hH subject to FAR 31.205-6(j)(7).

e. The auditor should closely review the reasonableness of special termination plans that offer both severance-type benefits and early-retirement-incentive-type benefits to the same employee. A well designed special termination plan usually does not need to offer both of these benefits to the same employee to achieve its goals to reduce levels of employment. Usually, if both types of benefits are included in the plan, the employee can choose one of them, but not both. However, the actual determination of allowability must be made considering the reasonableness of the entire termination plan (see 7-1907.7).

7-1907.2 Severance Pay Benefits

Contractors usually have a severance pay policy that pays employees a set number of weeks' pay based upon years of service. However, some contractors may provide additional termination benefits, such as medical care, education, and relocation expenses in order to reduce hardship to employees terminated as the result of a mass work force reduction process. These additional benefits also represent severance pay. The allowability of the total severance pay is subject to the reasonableness criteria contained in paragraph (b) of FAR 31.205-6, Compensation for Personal Services. Note that FAR 31.205-6(b) requires the contractor to demonstrate reasonableness of compensation items. It specifies factors to be considered in determining reasonableness, including the compensation practices of other firms in the same industry as well as the practices of firms engaged in non-government work.

7-1907.3 Severance Payments for Involuntary versus Voluntary Terminations

FAR 31.205-6(g) provides that severance pay is a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. This provision can be applied to both of the following situations. First, "involuntarily terminated" can refer to situations where the employee has no option of staying with the company. Secondly, "involuntarily terminated" can refer to situations where the contractor has an established goal for a reduction in work force. Whether or not any specific employee is given an option to stay is irrelevant, provided that the contractor has an established goal. The contractor's commitment to a work force reduction may be evidenced by providing assurance to the government that the terminated employees will not be replaced; i.e., their jobs have been abolished in order to reach the established goal. Reductions in the work force made under this second situation are often accomplished under special termination plans and may produce higher termination costs than would the contractor's previously established

termination benefits. The higher costs are allowable if reasonable (see 7-1907.7). Payments made for involuntary terminations are allowable subject to the provisions contained in FAR 31.205-6, while payments made for voluntary terminations are unallowable.

7-1907.4 Normal and Abnormal Severance Payments

a. FAR 31.205-6(g)(2) classifies severance pay as either normal or abnormal. Either is allowable only to the extent that in each case it is required by (1) law; (2) employer-employee agreement; (3) an established policy that constitutes, in effect, an implied agreement on the contractor's part; or (4) the circumstances of the particular employment.

b. Normal severance pay should be allocated to all work performed in the contractor's plant. When the contractor provides for accrual of pay for normal severances, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period and if the amounts accrued are allocated to all work performed in the contractor's plant.

c. Abnormal or mass severance pay is considered by FAR 31.205-6(g)(2)(iii) to be of such a conjectural nature that measurement of costs by means of an accrual will not achieve equity to both parties. Accruals for abnormal or mass severance pay are not allowable. However, when specific payments occur, allowability will be considered on a case-by-case basis. Severance paid under the terms of a special termination plan is generally abnormal severance.

7-1907.5 Severance Payments Made When There Is a Replacement Contractor

Severance payments made to employees who are to be employed by a replacement contractor are not allowable. For this purpose, employment by a replacement contractor occurs when continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility, subsidiary,

affiliate, or parent company of the contractor.

7-1907.6 Severance Paid in Addition to Early or Normal Retirement Benefits

a. Prior to 3 October 1988, FAR 31.205-6(g)(2)(i) provided that severance payments, or amounts paid in lieu of, are not allowable when paid to employees in addition to early or normal pension payments.

b. The prohibition of payment of both severance and pension benefits was deleted by Federal Acquisition Circular 84-39 effective 3 October 1988. The FAR now permits the payment of otherwise allowable severance and pension benefits concurrently, as well as sequentially, i.e., in the latter case, the contractor may delay payment of pension benefits until after the period for which severance pay is provided. In the circumstances where the contractor provides payment of both severance and pension benefits to the same employee, the auditor needs to closely review the plan to determine if the total plan costs are reasonable.

7-1907.7 Reasonableness of Special Termination Plan Costs

a. Contractors may offer special termination plans, which provide enhanced benefits, to achieve a work force reduction goal by inducing voluntary employee terminations. The rationale behind offering an enhanced severance payment, or an early retirement incentive, should be that the contractor will achieve lower overall costs which will offset the higher termination costs of the special plans. The costs of such plans could include loss of key personnel, higher severance costs (e.g., increased severance benefits for each employee class when compared to the normal plan and higher severance costs resulting from senior workers volunteering to terminate), and higher pension costs resulting from primarily the early retirement incentives. The primary cost reductions of such plans generally are lower overall compensation of the remaining employees, as well as reductions in recruiting and training needs in the near-term. For example, by inducing older employees to retire, the contractor retains younger, fully trained employees

who will not need to be replaced for a longer period of time and who are likely to be paid less than the terminated workers.

b. The contractor should be able to support a special termination plan with sufficient information to make a determination that the additional costs incurred by the special plan are offset by associated additional reductions in other costs. Both FAR 31.205-6(b)(1) and 31.201-3 require a contractor to demonstrate that its plan is reasonable.

c. In assessing the reasonableness of a plan, the auditor should consider the value of intangible benefits associated with employee morale and the contractor's reputation as an employer. However, there is no presumption that the government will allow the costs of such intangible benefits. If justification for a special plan is based on the value of intangibles, it would be an appropriate subject for an advance agreement with the government before the cost is incurred. (See FAR 31.109 for further discussion of advance agreements.) If the cost/benefit analysis includes intangible benefits and no advance agreement was executed, the auditor should discuss this matter with the contracting officer. If it is decided that the intangible items should be included in the cost/benefit analysis, the auditor should evaluate the reasonableness of the values assigned to those items. The auditor should question any unreasonable costs associated with the plan.

7-1907.8 Golden Parachute Plans

a. A "golden parachute" is a termination agreement which provides for the payment of extremely lucrative financial benefits, usually to a limited number of key executives. The termination or severance payments granted under the "golden parachute" arrangement are normally well in excess of normal severance payments. Such payments are paid only in the event the employee leaves the company following an actual or anticipated corporate merger or a transfer of control over the company. A common motivation for instituting a "golden parachute" plan is to discourage a hostile takeover by

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making the costs of a takeover prohibitively expensive.

b. The costs of "golden parachutes" were made expressly unallowable in FAR 31.205-6(l)(1) effective 4 April 1988. Costs of "golden parachutes" are not reasonable, do not benefit the government, and constitute costs incidental to reorganization because such agreements become operative only with the actual or anticipated corporate takeover. Accordingly, the auditor should also question costs of "golden parachutes" claimed by the contractor for contracts awarded prior to 4 April 1988 based on the cost principle provisions for reasonableness (FAR 31.201-3 and 31.205-6), allocability (the benefits received requirement at FAR 31.201-4), and organization costs (FAR 31.205-27). For costs of "golden parachutes" included in any billing, claim, or proposal submitted by the contractor for contracts awarded on or after 4 April 1988, the auditor should cite FAR 31.205-6(l)(1) as a basis for disallowing such costs. See also 7-1708.

7-1907.9 Severance Payments to Foreign Nationals

a. Effective 29 March 1989, service contracts to be performed outside the United States included the clause at FAR 52.237-8. The clause limits severance paid to foreign nationals performing services outside the United States to the amount typically paid to employees providing similar services within the United States. Effective 19 February 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective 30 October 1992, for DoD contracts.

b. Effective 21 December 1990, the clause at FAR 52.237-8 was revised to make such severance payments totally unallowable for terminations of employment resulting from requests of the host foreign government to close or curtail the employing activity. This prohibition of severance payments only applies to terminations of agreements between the United States and the host country entered into after 28 November 1989. Effective 19 February 1993, this coverage was removed from FAR 31.205-6,

37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective 30 October 1992, for DoD contracts.

c. The Defense Appropriations Act of 1992 (Section 346) allows DoD to waive the limitations on allowability of severance payments to foreign nationals for contracts for the operations of overseas military banking services.

7-1907.10 Severance Pay Policies for Paid Absences Under the Worker Adjustment and Retraining Notification (WARN) Act

a. The Worker Adjustment and Retraining Notification Act (WARN), sometimes called the Federal Plant Closure Law, 29 U.S.C. 2101, applies to employers with 100 or more full-time employees or to employers with 100 or more employees who in the aggregate work at least 4,000 hours per week (exclusive of overtime). The Act requires that employees be provided with a 60-day advance notice when a plant is to be closed or there is to be a mass layoff. A plant closure is defined as a permanent or temporary shutdown of a single site of employment one or more facilities, or an operating unit, where 50 or more employees (excluding part-time employees) lose their jobs. A mass layoff is defined as a reduction in force which is not a plant closing but which results in at least 33 percent of the work force (with a minimum of 50 employees) or 500 employees being terminated (excluding part-time employees).

b. The WARN Act allows employers to give notice to employees less than 60 days in advance when a business circumstance is such that it is not reasonably foreseeable at the time that the 60 day notice would have been required. In order to be not reasonably foreseeable, the event must be caused by a sudden, dramatic, and unexpected action or condition outside the employer's control.

c. A contract termination may result in a plant closure under the Act if it causes the shutdown of at least one site, facility, or operating unit. Shutdown of an operating unit will occur when there is the discontinuance of an entire product line or the extinction of an organizationally

distinct operation or function. The critical factor in determining what constitutes an operating unit will be the organizational or operational structure of the contractor. The circumstances of each contract termination should be reviewed and evaluated to determine if the contract termination resulted in a plant closure under the Act.

d. Where a contract termination results in a plant closure, and the contractor has exercised reasonable and prudent efforts in providing timely notification of the plant closing, costs incurred to comply with the WARN Act are generally considered allowable and reasonable business expenses under FAR 31.201-2 and 31.201-3.

e. Where the termination does not meet the provisions of the WARN Act, the auditor should determine if the contractor's actions were reasonable. For example, if the contractor terminates less employees than the minimum required for application of the WARN Act, any payments made for unproductive effort should generally be questioned as not meeting the test of payments for work accomplished in the current year. However, such payments would be allowable to the extent that the contractor can demonstrate that, given the circumstances at the time, it was reasonable to give the WARN Act notices and make the associated payments to the affected employees.

f. In some instances, contractors may place WARN Act status employees who are in sensitive positions on paid absence because of fear that those employees, if allowed to work during the 60-day period, might use their positions to harm the contractor's assets or records in retaliation for losing their jobs. There is no existing regulation or policy which specifically prohibits payments for such paid absence. The paid absence during the 60-day notice period could be considered additional severance pay. However, the contractor may claim the costs as some other category of cost associated with the reduction in force. FAR 31.205-6(b) requires that the contractor demonstrate reasonableness of compensation items and FAR 31.201-3 requires the contractor demonstrate the reasonableness of all

costs claimed. Therefore, it is incumbent upon the contractor to demonstrate why it believes the employees are a high risk and should not be working during the notice period. The contractor must also explain why these employees cannot be reassigned to perform nonsensitive work elsewhere in the plant and what the contractor's policy and procedures are in this situation. Without acceptable justification from the contractor, any claimed costs for paid absence during the 60-day notice period would be considered unreasonable and should be questioned.

7-1908 Industrial Security/Plant Protection Costs

a. The provisions of FAR 31.205-29, Plant Protection Costs, state that costs of protecting the contractor's plant and other property are allowable. The costs of items such as (1) wages, uniforms and equipment of personnel engaged in plant protection, (2) depreciation on plant protection capital assets, and (3) necessary expenses to comply with military requirements, are allowable provided they are reasonable and allocable.

b. There are now a number of commercial companies that provide plant security protection services, including well-trained uniformed guards. These security service companies often provide efficient plant protection services for less than the cost of such services performed by the contractor's own security employees. Accordingly, evaluation of costs of security guards at the contractor's facilities should include a comparison between the cost of the in-house services and the cost of engaging an outside security service firm. When excessive or unreasonable costs are questioned as a result of the above cost comparison, it is the contractor's responsibility to demonstrate the reasonableness and to justify the costs (see FAR 31.205-6(b)(1)).

7-1909 Costs of Correction of Internal Control Deficiencies

An internal control system comprises the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its

assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Internal controls extend to functions other than those relating to accounting controls; e.g., performance reports, employee training programs, and quality controls (see 5-105). This subsection provides guidance relating to the costs of correcting deficiencies in internal control systems or excessive costs that result from the lack of effective internal controls.

7-1909.1 Costs of Correcting Quality Control Program Deficiencies

a. Purpose of Quality Control. Effective contractor quality control or product assurance systems provide systematic control of quality and reliability in all phases of the operation including design, procurement, production, testing, storage, and handling of materials. Quality assurance systems consist of both quality control and inspection. The quality control system is responsible for maintaining the quality of the product within established standards. Inspection is a sorting process that classifies material, parts, or products as acceptable or unacceptable. As quality control becomes increasingly effective, the need for inspection correspondingly decreases. Weaknesses in or lack of effective control can result in:

- (1) Inadequate products or services;
- (2) Unnecessary and ineffective use of resources, including labor, material, and equipment;
- (3) Unreliable and inadequate analysis of quality assurance requirements and inspection results;
- (4) Unnecessary inspections and work stoppages;
- (5) Unreliable management reporting systems;
- (6) Unnecessary administrative effort; and
- (7) Unreliable test equipment.

b. Allowability of Costs.

(1) The cost of maintaining an acceptable quality control system is allowable, if reasonable. Where minor deficiencies are cited by the government, making corrections to the system should be considered to be part of maintaining an acceptable quality control system and

related costs are allowable. However, where significant corrections to the quality control system are needed because of the contractor's earlier negligence in establishing and/or maintaining acceptable controls, an unreasonable amount of increased costs to the government would result through duplicative efforts to reinstitute a quality control program. These costs should be disallowed on a basis of reasonableness (FAR 31.201-3).

(2) FAR 46.311 requires certain contracts to contain the contract clause at FAR 52.246-11, Higher-Level Contract Quality Requirement (Government Specification). This clause requires contractors' compliance with the specified government quality control specification requirements. Where this clause is contained in a contract, the contractor has a contractual obligation to establish and maintain a quality control program to assure adequate quality throughout all areas of contract performance, including design, development, fabrication, processing, assembly, inspection, test, maintenance, packaging, shipping, storage, and site installation. In these situations, the contract clause provides a contractual mechanism for requiring contractor corrective actions at no increased cost to the government. Where a contractor is in violation of the government quality requirements specified in a solicitation, a comment should be included in DCAA audit reports indicating that contract award should not be made until the deficiencies are corrected by the contractor. In addition, where contractor deficiencies are cited on existing contracts, the auditor should recommend the use of advance agreements for limiting government liability and segregation of the costs of correcting quality control system deficiencies (to allow audit visibility). If the contractor refuses to segregate these costs, recommend suspension of payment until proper accounting and segregation of costs are made.

7-1909.2 Costs Related to Extraordinary Reviews of Unsettled Overhead Costs

a. All contractors doing business with the government are required by FAR 31.201-6 to have adequate internal controls to assure that unallowable costs are

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not included in billings and claims submitted to the government. Some contractors may undertake large-scale reviews of unsettled overhead costs to identify unallowable costs that may have not been segregated and removed from overhead claims during the original processing of the transactions and/or the initial preparation of the billings or claims. This extraordinary effort is often the result of the contractor's earlier negligence in establishing, maintaining, and/or implementing an adequate system of internal control.

b. When the circumstances cited in paragraph a. above are encountered and the contractor is incurring or is expected to incur significant costs, the auditor should notify the contractor that the costs associated with such extraordinary reviews of unsettled overhead costs are considered to be unreasonable and will be questioned under FAR 31.201-3, Determining Reasonableness. The reasons to be cited are:

(1) The costs are not of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of a contract. The costs are duplicative of costs incurred for the same purpose in prior periods. The government has already reimbursed the contractor for the costs of preparing billings and claims for reimbursement. The fact that this task was not adequately accomplished does not entitle the contractor to additional reimbursement.

(2) The costs are the result of the contractor's failure to follow the requirements of generally accepted sound business practices and contract terms.

(3) The costs result from actions taken which were not those of a prudent businessman in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government, and the public at large.

7-1909.3 Costs Related to Contractor Self Governance Programs

Contractor activities under self governance programs such as CRAG (see 3-104.4e) are to be encouraged as a matter of DoD policy. Costs of such activities are allowable if reasonable in amount.

7-1910 Bank Fees

a. Some banks, in an attempt to obtain government contractors as clients, have offered financial agreements which grant lines of credit at less than the prime interest rate. Under these agreements, the difference between the rate granted by the bank and the prime rate (or the rate the bank wishes to obtain) would be classified as a bank fee which the contractor may be claiming as an allowable cost under government contracts.

b. FAR 31.205-20, Interest and Other Financial Costs, specifically disallows interest on borrowings, however represented. Accordingly, bank fees claimed by contractors should be carefully reviewed to determine whether they are, in fact, interest costs.

c. Where contractors have entered into agreements similar to that discussed in paragraph a. above, and claim the costs under government contracts, the procedures in 4-702 should be followed as applicable.

7-1911 No Cost Storage Contracts

7-1911.1 Definition

No Cost Storage Contracts are contracts for which the contractor is to provide the government with storage or warehousing services, but payment of the costs associated with these services is not provided for in the contracts. Some of these contracts specify that storage or warehousing costs are to be charged as an indirect expense. Other such contracts, while not specifically stating that the storage or warehousing costs are to be charged indirect, make no provision for reimbursement of such costs under the contract. The likely result is that the costs associated with the storage or warehousing are allocated to and reimbursed under other non-benefiting government contracts.

7-1911.2 Audit Considerations

a. Allocability of Costs. The provisions of FAR 31.201-4, Determining Allocability, and CAS 418 set forth criteria for determining the proper allocation of expenses to final cost objectives. Irrespec-

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tive of whether a contract provides for reimbursement of costs of particular items, the allocability of costs must be determined by the casual or beneficial relationship of the cost to the final cost objectives. Other contracts cannot bear the storage or warehousing costs that are properly allocable to the No Cost Storage Contracts (see 6-606 and 8-418).

b. Consistency in Accounting Treatment of Costs. FAR 31.202, Direct Costs, and CAS 402 state that all costs incurred for the same purpose in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. A noncompliance with FAR 31.202 and CAS 402 arises when some contracts are charged directly for storage costs, as well as indirectly for the storage costs that should have been charged to the No Cost Storage Contracts. Inconsistent accounting treatment of storage or warehousing expense should be reported as a noncompliance with these requirements (see 6-608.3 and 8-402).

c. Anticipated Awards of No Cost Storage Contracts. When an ACO, PCO, or commercial customer has requested the contractor to store property at no cost, the auditor should place the ACO and/or PCO, and the contractor on notice that the cost associated with the storage or warehousing should be allocated in accordance with the contractor's normal accounting practices and the criteria discussed in paragraphs a. and b. above. If necessary, discuss the issues with the cognizant ACO so that a written notice of intent to disallow costs on impacted contracts may be issued in accordance with FAR 42.8.

d. Active No Cost Storage Contracts. Where auditors identify No Cost Storage Contracts, any inappropriate allocation of costs should be questioned. If not already issued, appropriate CAS and/or FAR noncompliance reports and DCAA Forms 1, if applicable, should be issued. In these situations, the contractor may assert that the audit position would involve prejudicial retroactivity and may introduce estoppel as a defense. The validity of an asserted estoppel claim is a legal issue and the auditor should not attempt to resolve such arguments. Es-

toppel is a matter which normally should be considered by contracting officers and procurement counsel subsequent to the issuance of the audit results. However, if an auditor perceives that an estoppel issue may affect an audit, the matter should be referred to the Regional Director for appropriate legal consultation.

7-1912 Banked Vacations**7-1912.1 General**

a. The term "banked vacations" refers to a situation where contractors have policies that allow employees to carry forward and accumulate (bank) all or a portion of vacation time not taken within the year in which entitlement is earned. The banked vacation can be taken at a later date or not taken at all, in which case payment for the amount of banked vacation time is usually made when the employee terminates employment. Sometimes contractors write up the vacation liability on the books to reflect employees' pay raises received subsequent to the periods in which vacation was earned.

b. CAS 408 does not address the practice of banking vacations, nor does CAS 415 specifically apply to compensated absences. Therefore, auditors should not issue CAS 408 or CAS 415 noncompliances because of problems with the contractors' policies/practices regarding banked vacations.

7-1912.2 Audit Considerations

a. Many contractors have ceased the practice of banking vacations, (i.e., have adopted a use-or-lose policy), or now allow deferral for only one accounting period following the year in which the vacation was earned. Nevertheless, if the situation of banked vacations exists, the auditor must first determine if the contractor's method of accounting for banked vacation accruals is proper, and then look at the reasonableness of the vacation policy and costs as a component of total compensation.

b. A contractor normally accrues vacation liability as each employee earns vacation. It is appropriate for a contractor's books to reflect the liability that will have to eventually be paid. Therefore the

contractor, for financial accounting purposes, may decide to write up the vacation accruals; otherwise the accruals on the books may be understated. If banked vacation deferrals extend beyond one year and related write-ups are significant, the auditor should recommend that the ACO seek an advance agreement with the contractor establishing mutually agreeable criteria for calculating banked vacation accruals including consideration of present value methodology.

7-1913 Payments to Contractors Under the Job Training Partnership Act

a. The Job Training Partnership Act was passed by Congress to help turn the hard-core unemployed into productive wage earners. As part of that effort, local Private Industry Councils (PIC) were created to identify, counsel, train, and place unemployed people. One incentive to industry to participate in the program is a partial subsidization of these new workers' wages, up to 50 percent, for the first weeks or months of their employment. The law further specifies that these PIC reimbursements are intended to compensate employers for the increased training costs and reduced productivity associated with hiring the hard-core unemployed.

b. Contractors receiving PIC payments as part of this program should not receive duplicate reimbursements under government contracts. If the contractor includes costs in its proposals or billings that are subject to PIC reimbursement, an appropriate credit should be given to the government. Conversely, if the contractor can and in fact does exclude from its proposals or billings increased costs resulting from its participation in the PIC program, then no credit or offset is required. Such increased costs often result from additional training and supervision that are associated with hiring the hard-core unemployed as well as reduced productivity in the form of additional hours and materials required by these employees.

7-1914 Employee Stock Ownership Plans (ESOPs)

7-1914.1 General

a. An Employee Stock Ownership Plan (ESOP) is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. An ESOP may be either nonleveraged or leveraged.

b. An Employee Stock Ownership Trust (ESOT) is the entity responsible for administering the ESOP. The contractor's contributions to the ESOT may be in the form of cash, stock, or property.

c. Under a nonleveraged ESOP, annual contributions are made by the corporation to the ESOT in the form of stock, property, or cash. If the contribution is in the form of cash, the ESOT uses this cash to acquire company stock. The ESOT holds the stock for the employees and periodically notifies them of how much they own and how much it is worth. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

d. Under a leveraged ESOP, the ESOT borrows money from the bank and then uses these funds to make a large purchase of company stock, either from the shareholders or from the company, e.g., treasury stock. This stock then becomes collateral for the bank loan. Each year the company makes a contribution to the ESOT equal to the total amount of the principal and interest on the loan. The ESOT then uses this money to make its annual payment to the bank. Upon receipt of the ESOT loan payment the bank releases an amount of stock in proportion to the loan principal paid by the ESOT. The released stock is then distributed by the ESOT to the accounts of the plan participants in accordance with the provisions of the plan. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

7-1914.2 Pension Versus Deferred Compensation ESOPs

a. For a plan to be a pension ESOP, the official plan documents must offer the

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plan participants (1) benefit payments for life or (2) benefits that are payable for life at the option of the participants. Some contractors may contend that a pension ESOP exists where there is no official plan provision for life payments, because the contractor has made some informal provisions to cash in the employer's stock and purchase an annuity for the employee. Such informal provisions are not enough to meet the "payable for life" requirement for pension plans, nor are these informal provisions enforceable by the employee.

b. Plans that provide future payments for current work, and that are not pensions, are deferred compensation ESOPs.

7-1914.3 Applicable FAR/CAS

a. The reasonableness of all ESOP costs must be supported in accordance with FAR 31.205-6(a) and (b). In assessing the reasonableness, the auditor should review the terms of the ESOP to determine if the plan design provides unreasonable compensation to certain employees or groups of employees. In addition, the reasonableness of the amount of stock distributed to employees should be reviewed in conjunction with a review of the employees' total compensation (see 5-1000).

b. Under leveraged ESOPs, for any given period the shares released from collateral under the terms of the loan may exceed the number of shares to be allocated under the terms of the plan. The auditor should be alert to excess shares that might be awarded to ESOP participants and claimed by the contractor. In the absence of the Contracting Officer's prior approval, the award of excess shares to ESOP participants should be questioned, since the excess shares are not awarded according to the established compensation plan.

c. Contractor contributions to a pension ESOP must meet the requirements of CAS 412 and FAR 31.205-6(j), while contributions to a deferred compensation ESOP are subject to the requirements of CAS 415 and FAR 31.205-6(k).

d. CAS 415.50(e)(1) requires that the cost of deferred compensation awards, when such awards are made in the stock of the contractor, shall be based on the

market value of the stock on the measurement date, i.e., the first date the number of shares are known. For deferred compensation ESOPs, the date the contractor transfers the stock to the ESOP trust or pledges the stock as loan collateral on behalf of the ESOP trust is the first date that the number of shares awarded is known. Thus, for leveraged ESOPs, costs assignable to a cost accounting period will be the fair market value of the stock on the date the contractor transfers the stock to the ESOP trust or pledges the stock as loan collateral on behalf of the ESOP trust, multiplied by the total number of shares actually earned for that period.

7-1914.4 Stock Valuations

a. The auditor should perform audit tests to determine that the contractor is not reimbursed an amount exceeding the fair market value of the stock on the measurement date. Where a leveraged buyout is involved, the price per share immediately after the buyout represents the value of the stock to be distributed to contractor employees. As such, the fair market value of the stock should be based on the contractor's debt/equity structure immediately after the buyout.

b. For stock that is publicly traded in substantial quantities, the published trading price on the measurement date should reflect the fair market value of the stock. For companies where the stock is not publicly traded in substantial quantities, a valuation is required. The annual appraisal of the ESOP stock should serve as the baseline for the auditor's review.

c. Valuation of stock for a company that is not publicly traded in substantial quantities is a complex process. While there is no formula that can be applied to all circumstances, the auditor should determine if the data used in making the valuation is current, accurate, and complete, and if the assumptions underlying the valuation are reasonable. In addition, the auditor should determine if appropriate adjustments have been made to reflect minority interests and/or lack of marketability.

d. Discount for Minority Interest—The fair market value of the ESOP stock should include a discount to reflect a

minority interest whenever the voting rights of the ESOP stock are held by an individual, group, or entity whose members are selected and/or otherwise controlled by the contractor (e.g. the ESOT). The discount for minority interest represents the additional cost per share needed to obtain a majority (control) interest divided by the majority cost per share.

(1) Where the ESOP stock has been obtained as part of a buyout, the additional cost can generally be computed by taking the difference between the actual cost paid per share and the value of the stock prior to any knowledge or speculation (e.g., leaks or rumors) of the upcoming buyout. This value must be close enough in time to be relevant to the buyout (preferably one or two months) but should not be a time period in which there were significant events that led to changing market conditions (e.g., stock market crash or product boycott).

(2) Where a leveraged buyout is not involved, the discount should be based on historical data regarding similar companies that have been bought or sold within a relevant time period. If no such data exists, then overall market information may be used.

e. Discount for Lack of Marketability—Where the stock is not publicly traded, it should generally be discounted to reflect its lack of marketability. A marketability discount reflects the fact that the stock of a closely held company is generally less attractive to potential investors than publicly traded stock.

(1) Even when the company has always exercised its option to repurchase the stock, or where the plan requires the company to repurchase the stock (called "put" rights), some discount will usually apply. While the amount of the marketability discount will differ depending upon the specific circumstances involved, such discounts have generally ranged from 5 to 20 percent.

(2) Factors that influence the amount of the marketability discount include the extent to which "put" rights are enforceable, the company's ability to meet its obligations with respect to these "put" rights (taking into account the company's financial strength and liquidity), the company's history of redeeming its ESOP

shares for cash when tendered, and the establishment of a funding program for the repurchase liability.

7-1915 Cooperative Research Consortium Costs

7-1915.1 Introduction

This section provides guidance for performing audits of cooperative research consortiums. This guidance is specifically targeted at partnerships, joint ventures, or corporations (referred to in this section as consortiums) formed pursuant to the National Cooperative Research Act. Guidance on other organizational structures chosen by a contractor to carry on its business or to bid on government contracts is provided in 7-1800.

7-1915.2 General

In 1984, Congress passed the National Cooperative Research Act. This act eased antitrust laws to allow companies in the same industry to jointly develop new technology. Under the Act, research and development is usually funded cooperatively to develop base technology for use by member firms individually in proprietary applications. The Act covers research and development activities up to the prototype stage. Cooperative research consortiums are usually formed to explore specific research areas.

7-1915.3 Accounting Considerations

a. While the terms and conditions of these agreements may suggest they are contracts, they are not the type of contract contemplated under FAR 31.205-18(a) that would preclude the recovery of IR&D costs. R&D costs incurred by a defense contractor pursuant to a cooperative agreement may be considered as allowable IR&D costs if the work performed would have resulted in allowable IR&D costs had there been no cooperative agreement.

b. Consortium costs will most likely be charged to indirect cost pools, primarily as Manufacturing and Production Engineering (MPE) or IR&D. The audit review of consortium costs must consider the different accounting treatment afforded MPE costs versus IR&D costs. As

MPE, the costs are not subject to ceiling limitations imposed by IR&D/B&P advance agreements and are charged to the government through G&A and overhead allocations. Because the cost limitations of IR&D and B&P advance agreements are often exceeded, the proper classification of consortium costs is particularly important, and depends on the nature and purpose of the work being conducted at the consortium.

c. MPE (FAR 31.201-25) does not cover basic and applied research effort related to new technology, materials, systems, processes, methods, equipment, tools, and techniques. These are all covered by the IR&D/B&P cost principle, FAR 31.205-18. Nor does MPE cover any development effort for manufacturing or production materials, systems, process, methods, equipment, tools and techniques, that are intended for sale. These costs are also covered by the IR&D/B&P cost principle. MPE covers only developing and deploying new or improved methods of producing a product or service when such new or improved technology is to be used in the contractor's own productive facilities.

7-1915.4 Classification of Costs and Audit Considerations

a. To properly classify consortium costs, the nature and purpose of the projects involved must be determined. Although FAR clearly delineates between IR&D and MPE costs, the technical nature of this work may make it difficult to distinguish between independent research and development and development effort not intended for sale. To assist the auditor in making these decisions, government technical specialist assistance should be sought. Procedures for identifying and obtaining technical specialist assistance are outlined in Appendix D.

b. The contractor should be able to provide documentation to support the nature and purpose of consortium projects. The contractor should also provide all legal documents (e.g., partnership agreements, shareholder agreements, certificates of incorporation, technology agreements) which pertain to the creation of the consortium. These documents of-

ten contain valuable information regarding the purpose of the consortium as well as information on other accounting issues such as income/loss distribution, payment schedules, and ownership of products or technology developed by the consortium.

c. When reviewing the nature and purpose of specific projects engaged in by a consortium, the following additional sources of information may prove helpful: (1) contractor interoffice memos discussing the project, (2) articles in company newsletters or journals, (3) slides/charts/minutes from company briefings or conferences, (4) papers or speeches to professional organizations or conferences, and (5) newspaper articles.

d. In addition to the distinction between MPE costs and IR&D costs, there are other important audit considerations pertaining to consortiums.

(1) Costs for consortiums may be charged to an account for trade and professional organizations. Included in these costs may be both basic membership fees and sponsorship fees for specialized research and development programs. The classification and allowability of these sponsorship fees will depend upon the nature and purpose of the research programs and the company's intended use of the resulting technology.

(2) An important consideration is the accounting treatment given any income/loss of the consortium. Usually, the consortium agreement provides for distribution of net income/loss to the individual member companies. The applicable portion of any income relating to allowable cost should be credited to the government in accordance with FAR 31.201-5.

(3) There may be significant related party transactions between the consortium and its members. A consortium may hire one or more member companies to provide a variety of services. For example, a member company may provide a consortium with executive search services or legal support. The applicable portion of any payment relating to an allowable cost should be credited to the government in accordance with FAR 31.201-5.

(4) The employees of a member company may be temporarily assigned to the consortium. The consortium may reimburse the company for employees' salary and relocation expenses. The accounting for the employee's salary and any reimbursement a member company receives for the loan of its employee should be determined.

7-1916 Lobbying Costs

Lobbying costs represent amounts incurred to influence the outcome of elections, referendums, legislation, and other governmental actions at all levels of government.

7-1916.1 Lobbying Cost Principles

a. FAR 31.205-22 disallows most costs incurred to influence elections, public votes on issues, political parties, and legislation. FAR 31.205-50 disallows costs incurred to induce or tend to induce, either directly or indirectly, executive branch employees to give consideration or to act regarding a government contract on any basis other than the merits of the matter. FAR 31.205-22(b) states that the following lobbying costs are allowable:

(1) Costs that result from requests by a legislative body for certain types of information.

(2) Costs for influencing state legislation in order to directly reduce contract cost or to avoid material impairment of the contractor's authority to perform the contract.

(3) Costs for performing any activity specifically authorized by statute to be undertaken with contract funds.

b. FAR 31.205-22 sets forth requirements for supporting and claiming allowable costs and for disclosing unallowable costs that are not claimed. The contractor specifically certifies, as part of the indirect final cost settlement proposal certification, that the requirements of the cost principle and the contract clause (see 7-1916.2) are met. Unallowable lobbying costs must be separately and specifically disclosed in the submission as voluntary deletions from the contractor's final costs for the period. Lobbying costs may not be removed from the submission as part of

an undifferentiated total which includes other types of costs. Likewise, a contractor may not simply exclude the costs without identifying that the costs were incurred and removed.

7-1916.2 Lobbying in Connection with Federal Contracts and Other Federal Actions - Byrd Amendment

a. FAR Subpart 3.8 implements 31 U.S.C. 1352, entitled "Limitation on Use of Appropriated Funds to Influence Certain Federal Contracting and Financial Transactions." This legislation, which was signed into law on 23 October 1989, is commonly referred to as the Byrd Amendment. The legislation has been implemented by contract clause, as opposed to a change in the FAR cost principles. Effective 23 December 1989, solicitations exceeding \$100,000 are required to include the clauses at FAR 52.203-11 (Certification and Disclosure Regarding Payments to Influence Certain Federal Transactions). Effective 23 December 1989, both solicitations and contracts are required to include the clause at FAR 52.203-12 (Limitation on Payments to Influence Certain Federal Transactions).

b. FAR clause 52.203-12 makes the cost of certain lobbying activity unallowable. The activity covered is influencing or attempting to influence an officer or employee of an agency, a Member of Congress, an officer or employee of Congress, or an employee of a Member of Congress in connection with any covered Federal action. A covered Federal action is defined as (1) the awarding of any Federal contract, (2) the making of any Federal grant,

(3) the making of any Federal loan, (4) the entering into of any cooperative agreement, or (5) the modification of any Federal contract, grant, loan, or cooperative agreement.

c. The Act does not apply to the following activities:

(1) Providing information specifically requested by a Member of Congress, an employee of Congress, an employee of a Member of Congress, or an officer or employee of a Federal agency.

(2) Agency and legislative liaison by a contractor's regularly employed employ-

ee, provided the activity is prior to or not directly related to a specific solicitation.

(3) Selling activities by independent sales representatives, provided such activities are prior to formal solicitation and limited to the merits of the matter.

(4) Professional or technical services rendered directly in the preparation, submission, or negotiation of a bid or proposal, provided such services are limited to providing advice and analysis which directly applies a professional or technical discipline and are further limited to the merits of the matter.

7-1917 Costs Associated With Military Operations

7-1917.1 War Hazard Pay

a. Contractors will sometimes offer hazardous duty pay as an incentive to employees performing work under unusually dangerous situations. These incentives vary among contractors and may reflect differences in individual circumstances. Such incentives are to be evaluated for reasonableness on a case-by-case basis. Each contractor should support the reasonableness of the incentives by presenting evidence that may be relevant to the particular circumstances. War hazard differentials may well be justified in order to ensure that critical functions are maintained in support of our troops.

b. The amount of war hazard pay necessary in a given situation will depend on many factors, such as:

- (1) Country and city where assigned,
- (2) Distance of work site from actual battlelines and surrounding areas of imminent danger,
- (3) War hazard differentials being offered by other defense contractors in the same location,
- (4) Employee response to any lower war hazard differential pay offers made by the contractor,
- (5) Availability of alternate workers at appropriate skill level, and
- (6) Other compensation offered, such as bonuses and insurance coverage.

c. Auditors should review the reasonableness of the process by which the war hazard differentials are set without any preconceived idea of what percentage or

dollar amount is to be accepted as reasonable. Whatever policy the contractor sets should be consistent to ensure that the contractor is not paying the war hazard differential only where it can be reimbursed on government contracts (e.g., flexibly priced contracts). Contractors should also be encouraged to set forth their policy in writing to the cognizant ACO and enter into an advance agreement to avoid misunderstandings.

7-1917.2 Supplemental Reservist Payments

a. In accordance with a 4 October 1990 memorandum issued by the Director of Defense Procurement, supplemental reservist payments are allowable when paid to employees who served on active military duty in conjunction with Operation Desert Shield and Operation Desert Storm.

b. Allowable amounts are limited to the lesser of (a) the contractor's extended military leave benefits plus active duty pay, or (b) the total compensation of an employee at the time of entry into active military duty. For purposes of computing this limitation, active duty pay includes basic pay, all specialty pay, and all allowances, except for subsistence, travel, and uniform allowances.

7-1917.3 Operation Desert Storm Homecoming Celebration Expenses

a. In accordance with a 3 June 1991 memorandum issued by the Director of Defense Procurement, Operation Desert Storm homecoming activities are considered to be a national celebration. If costs are incurred for participating in honoring the Desert Storm troops and celebrating the operation's success, this section applies.

b. As a general rule, the costs of participation are allowable because participation costs are considered as being incurred in different circumstances than public relations or advertising costs. However, costs which would otherwise be specifically unallowable are still unallowable (see 7-1917.3e).

c. Allowable contractor participation costs include labor, material, and other direct costs of the celebration. Employee time to participate in the activities could

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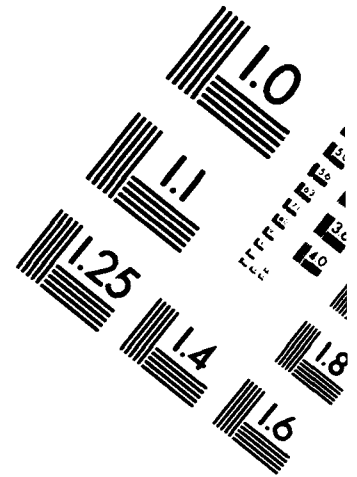
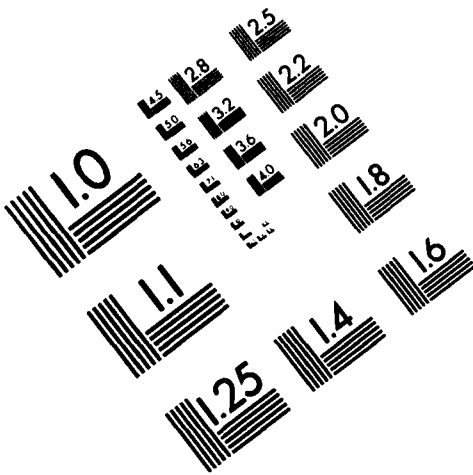


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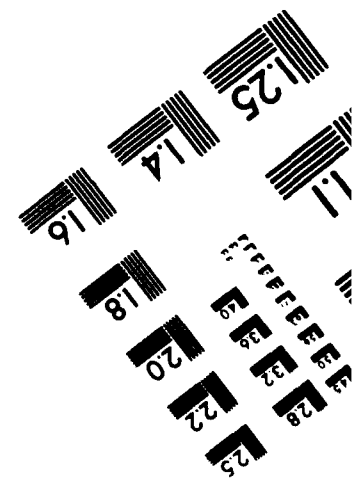
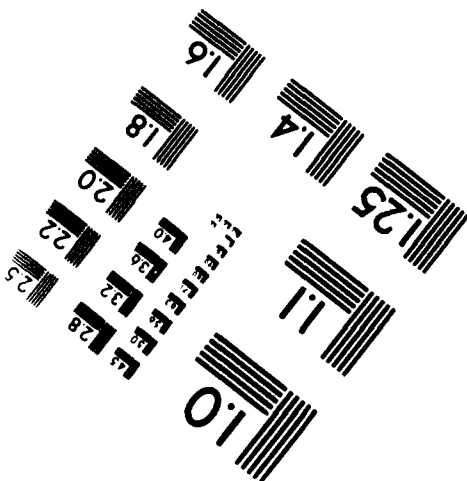
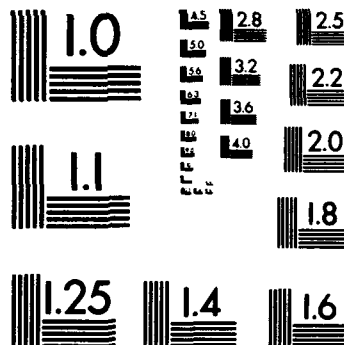
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include time to march in a parade or fabricate a parade float. Contractors should be allowed material and other direct costs of floats, displays, or exhibits appropriate to the celebration activity. Generally, the allowability of such costs is linked to employee morale and will normally involve celebrations in the locality of the contractor facility. While there is no specific limit on the number or location of celebration activities that would be allowable for a contractor, there should be a clear linkage to employee morale.

d. Employee absence from the workplace to attend the celebrations is allowable if the associated costs are reasonable. Most celebration activities were scheduled for holidays or weekends when there would be little or no contractor costs for employee attendance. When activities were scheduled for normal work time, reasonable personal absence costs are allowable.

e. Certain costs remain unallowable even if associated with such celebrations. Any advertisement to the public of any nature is subject to FAR 31.205-1, although the contractor is allowed to include its name and logo on a banner, sign, and/or float used in the celebration activity. Costs of souvenirs, models, imprinted clothing, buttons, and other mementos distributed during the celebration are unallowable under FAR 31.205-1(f)(6). Contributions to local governments or other third parties to pay for celebration activities are unallowable contributions under FAR 31.205-8.

7-1918 Costs Related to Legal and Other Proceedings

a. The specific conditions for allowability of costs associated with legal and other proceedings are addressed in FAR 31.205-47. The cost principle applies to the total costs incurred for the subject purpose including all costs directly associated with legal and other proceedings.

b. The costs of legal services as addressed in the cost principle encompass both (1) services rendered by attorneys who are not officers or employees of the contractor and (2) legal work performed

in-house (usually in a legal department) (FAR 31.205-47(a)).

c. Cost of outside legal services should be supported by invoices or billings which itemize such items as amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, and travel and miscellaneous expenses (FAR 31.205-33(f)).

d. In-house legal costs include salaries and related fringe benefits as well as the costs of secretarial and other support services, space, utilities, and library services. If a contractor maintains a legal capability in-house, the use of outside counsel should be limited to matters beyond the competence or workload capacity of the contractor's own legal department.

7-1918.1 General Considerations on Legal Services

a. Outside legal services and outside support for legal services are generally considered as specific kinds of professional or consultant services subject to the provisions of FAR 31.205-33, as discussed in 7-1905.

b. Costs of in-house legal services ordinarily cover a variety of legal activities related to the overall administration and management of the contractor's business. They are usually accounted for without further identification as part of in-house general and administrative expenses. Audit determinations on allowability will generally be made in consideration of the overall amounts involved. The auditor should not undertake, or request the contractor to undertake, a detailed analysis to classify costs by function or specific activity unless an overall review indicates that the amount is obviously excessive or that a significant portion of the effort of legal personnel was devoted to activities designated in FAR 31.205 as unallowable or not allocable to government business (but see 7-1918.9).

7-1918.2 Definitions

a. "Cost," as used in FAR 31.205-47, includes all costs which would not have been incurred but for the proceeding. This includes costs incurred before, during, and after the proceeding. The con-

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cept of "before the proceeding" should be interpreted to cover the following: (1) when a contractor anticipates and begins to prepare for a proceeding before it has been officially notified that a governmental unit has initiated a proceeding and (2) when the contractor is conducting its own investigation or inquiry preparatory to initiating a proceeding.

b. A proceeding includes any investigation, administrative process, inquiry, hearing, or trial conducted by a local, state, Federal, or foreign governmental unit and appeals from such proceedings. Note that for the purposes of this cost principle, the term proceeding includes, but is not limited to, those related to actions which in nature are criminal, non-criminal, fraud, non-fraud, contract-related, or non-contract-related. The definition is very broad.

c. A penalty does not include a payment to make a unit of government whole for damages or the interest accrued on the damages. A penalty is in the nature of a punitive award or fine.

7-1918.3 Allowability of Costs

Costs of some proceedings are allowable subject to a ceiling if the contractor prevails in an action, some are always unallowable, and others are completely allowable if the contractor prevails in an action. Costs associated with routine proceedings, not specifically addressed in the FAR cost principle, are generally allowable.

7-1918.4 Allowable Cost Ceiling for Certain Proceedings

a. If the outcome of a proceeding described in FAR 31.205-47(b) determines costs to be allowable, the maximum amount allowable is still limited to the extent that the costs:

(1) are reasonable considering the requirements and underlying cause of the proceeding;

(2) have not been otherwise recovered from any source; and

(3) do not exceed 80 percent of the total otherwise allowable cost. A percentage less than 80 percent could be appropriate considering the circumstances of the case and the legal work involved.

b. The "80 percent or appropriate amount" ceiling limitation is waived for a Federal government proceeding if the proceeding is resolved by a settlement which explicitly states that the settlement amount has considered the 80 percent limitation and sets a specific dollar amount of allowable costs related to the proceedings (FAR 31.205-47[e]). That specific amount would be the maximum allowable amount. The ceiling cannot be waived for proceedings settled with a unit of government at any level other than the Federal government (but see 7-1918.5c).

c. The unallowable portion (amount over the ceiling) is considered to be a co-payment to encourage contractors to incur proceedings costs responsibly even in a winning case.

7-1918.5 Proceedings Allowable Subject to a Ceiling if the Contractor Prevails

a. Costs of proceedings commenced by a governmental unit (Federal, state, local, or foreign) for violation of, or a failure to comply with, law or regulation are unallowable if the following proceedings result in the indicated outcomes; otherwise, costs are allowable subject to the ceiling (FAR 31.205-47[b]):

(1) A criminal proceeding; a conviction.

(2) A civil or administrative proceeding involving an allegation of fraud or similar misconduct; a finding of liability.

(3) A civil or administrative proceeding not involving an allegation of fraud or similar misconduct; an assessment of a monetary penalty.

(4) A proceeding held by an appropriate official of an executive agency for

(a) debarment or suspension of the contractor;

(b) rescission or voiding of a contract; or

(c) termination of a contract for default because of violation of or noncompliance with a law or regulation.

In each case in (4), the controlling outcome is a final decision unfavorable to the contractor.

(5) Any proceeding shown in (1) through (4) which could have led to the associated outcome; outcome is settlement by consent or compromise. If the contractor, its agent, or its employees

were at risk of one of the stated outcomes of the above proceedings and the proceeding is settled by consent or compromise, the settlement is treated as a loss for purposes of allowability of the costs.

b. Any costs of a proceeding involving the same underlying alleged contractor misconduct addressed in another proceeding whose outcome determined the costs to be unallowable (see a. above) are also unallowable (FAR 31.205-47[b][5]). If a contractor loses, settles, or compromises one proceedings associated with alleged contractor misconduct, all litigation costs for all other proceedings related to the same misconduct are also unallowable.

c. Unallowability of costs under FAR 31.205-47(b) or (e) for a non-Federal government proceeding may be waived when an appropriate cognizant U.S. Government official determines that the costs were incurred either (FAR 31.205-47[d]):

- (1) as a direct result of a specific term or condition of a Federal contract; or
- (2) as a result of compliance with specific written direction of the cognizant contracting officer.

7-1918.6 Proceedings Which Are Always Unallowable

a. Defense or prosecution of claims or appeals against the Federal government (FAR 31.205-47[f][1]). This includes the cost of preparing and presenting an appeal before a board of contract appeals (see Lear Siegler, Inc. [1979] ASBCA No. 20040, 79-1).

b. Organization, reorganization, mergers, or acquisitions, or resistance to merger or acquisition (FAR 31.205-47[f][2] and FAR 31.205-27).

c. Defense of antitrust suits (FAR 31.205-47[f][3]).

d. Defense or prosecution of lawsuits or appeals between contractors arising from such agreements as teaming arrangement, dual sourcing, co-production, or similar programs. However, these costs are allowable if incurred as a result of compliance with specific terms and conditions of the contract or written instructions or approval from the contracting officer (FAR 31.205-47[f][5]).

e. Patent proceedings if not required by the contract. This does not include gener-

al counseling services such as advice on patent laws and regulations. (FAR 31.205-30, FAR 31.205-47[f][6]). Also see 7-702.

7-1918.7 Proceedings Allowable Without Cost Ceiling if the Contractor Prevails

Costs of the following proceedings are unallowable with the stated outcome; otherwise, the costs are allowable without the 80 percent ceiling:

a. Defense of suits brought by employees or ex-employees of the contractor under Section 2 of the Major Fraud Act of 1988 when the contractor was found liable or the case was settled (FAR 31.205-47[f][4]).

b. Representation of, or assistance to, individuals, groups, or legal entities that the contractor is not "legally bound" to provide, arising from an action where the party being represented or assisted was convicted of a violation of law or regulation or was found liable.

7-1918.8 Proceedings Related to Bid Protests

Costs of bid protest proceedings may be claimed by both the protestor and the contractor. There are many factors as discussed in this section that need to be considered when reviewing the allowability of bid protest costs.

a. The ASBCA has ruled that bid protest costs are not unallowable under FAR 31.205-47(f). In *Bos'n Towing and Salvage Company*, ASBCA 41356, the Board ruled that "claim" as used in FAR 31.205-47(f) is "term of art" which refers to a contract disputes claim and bid protests do not fall within that definition. Therefore, FAR 31.205-47(f) should not be cited as the basis to question bid protest costs.

b. Whether a protestor is successful or unsuccessful in its bid protest, the costs of the protest are allowable if reasonable. For a successful protest, the protestor may receive, as part of the proceeding, the reasonable costs of the bid protest. Auditors should assure any funds awarded are credited to the account where the protest costs had been charged.

c. A contractor who received the contract award being protested, may incur legal expenses in defending against a bid

protest as an "interested party". In Jana, ASBCA 32447, the Board ruled that bid protest costs may be charged directly to the contract if the costs fit the FAR 31.202 definition of a direct cost. However, the Board disallowed direct bid protest costs which were incurred before the contract award date because they did not meet the precontract costs requirement that the costs must be necessary to comply with the proposed contract delivery schedule (FAR 31.205-32). Therefore, bid protest costs incurred before the contract award date are not allowable direct costs.

d. The Jana decision discussed above would not preclude the contractor from adopting an accounting practice to charge all legal expenses indirectly, including bid protest costs. However, the contractor's practice must result in an equitable distribution of the cost and the contractor must follow its disclosed accounting practice consistently.

7-1918.9 Segregation and Withholding of Proceedings' Costs

a. FAR 31.205-47(g) requires that costs of a proceeding whose outcome determines cost allowability be segregated by the contractor and payment be withheld by the contracting officer until the outcome is determined. Thus costs described in 7-1918.5 and 7-1918.7 should be segregated as incurred and not billed to the government until the outcome is determined.

b. The contracting officer may enter into an advance agreement to make conditional payments to the contractor for such potentially unallowable costs if the contractor agrees to repay the government with interest if the ultimate outcome of the proceeding makes the cost unallowable. In advising the contracting officer about such agreements, it should be noted that most such proceedings' costs are subject to the 80 percent ceiling even when the contractor wins. Therefore, the 20 percent over-ceiling amounts are not billable even with an advance agreement.

c. Costs related to proceedings which are unallowable regardless of the outcome (7-1918.6) are required to be segregated and removed from government

billings in accordance with CAS 405 and FAR 31.201-6.

d. Costs incurred using outside counsel or other outside resources should be easily identified and segregated. For costs incurred in-house, the contractor will need to have internal controls in place to identify costs as they are being incurred pursuant to the proceedings described in 7-1918.5, 7-1918.6, and 7-1918.7.

e. The contractor is not required to anticipate whether a routine inquiry or action will result in a potentially unallowable cost proceeding. Cost identification to (or incurrence for) a particular proceeding cannot begin before the contractor has notice of the proceeding, unless the contractor anticipates such a proceeding and on its own begins to incur costs. Anticipatory costs incurred by a contractor are considered to be related to a proceeding even if the unit of government has not notified the contractor of the proceeding, or even if the contractor stops its preparations for a proceeding without notifying the government. A specific notifying event or a contractor anticipatory decision, accompanied by incurrence of significant costs, triggers the segregation and withholding.

7-1918.10 Audit Considerations

a. The regulatory history for FAR 31.205-47 includes the following guiding principles which should be considered in applying the cost principle to specific cases:

(1) The government should not pay for wrongdoing, the defense of wrongdoing, or the results or consequences of wrongdoing by contractors.

(2) The government should not encourage litigation by contractors.

(3) Government contractors should not be put in a better position than contractors in the commercial area.

(4) The government should not discourage contractors from enforcing the government's rights and protecting the government's interests.

b. The auditor should review costs segregated by the contractor to determine that all known unallowable and potentially unallowable proceedings costs have been included.

c. Legal services cost billings and other documents related to unallowable proceedings should be carefully reviewed to identify other unallowable proceedings and professional service costs which should also be segregated. Any in-house support costs (particularly in the legal and accounting departments) incurred for unallowable types of proceedings should also be segregated.

d. The review of internal controls over legal costs should determine if the contractor has adequately trained its employees to recognize proceedings subject to the cost principle. Particular attention should be given to non-contract proceedings which might not be obvious and could be handled by attorneys not normally involved in Federal contract law. For example, disputes over a municipal ordinance or an IRS inquiry could all be subject to penalty and as such could be unallowable depending on the outcome.

e. In-house legal staff handles routine inquiries from government agencies. Replies to such inquiries are not considered to be related to proceedings triggering segregation and withholding unless the contractor has specific knowledge that the inquiry is pursuant to a proceeding type listed in the cost principle or the contractor for its own reasons chooses to treat the inquiry as preparatory to an anticipated proceeding. A contractor might make such a choice because of other knowledge it has of the subject of the inquiry or any other reason to believe that it may be at risk.

f. If the contractor's internal controls for its in-house legal services are adequate, segregation of insignificant in-house costs related to minor proceedings (five-minute telephone calls and routine reply letters) should not be required. Aggressive defense or prosecution of proceedings listed in the cost principle cannot be considered insignificant, i.e., pleading not guilty, or appearing in court to make arguments, extensive in-house investigation, or other support activities.

g. Contractor responses to or support of audits by DCAA are not proceedings subject to disallowance within the meaning of the cost principle. Although criminal and civil proceedings have sometimes started as the result of DCAA audits,

there is no presumption of a proceeding subject to the cost principle until an agency with sufficient authority opens such a proceeding and the contractor is notified. If a contractor chooses to treat the audit as a covered proceeding or to begin preparations for an appeal before a final decision is made, then the contractor cost associated with such preparations for a proceeding would be subject to segregation. The level and nature of the contractor's response would determine its treatment.

Questioning costs in such a circumstance would be a sensitive matter. Any action which discouraged a full response from the contractor at the earliest point in the audit and negotiation process would be counter-productive to the speedy resolution of issues. Nevertheless, if the contractor begins extensive or specific activities obviously aimed at appeal of a contracting officer's decision or any other listed proceeding before an official decision or proceeding, the costs must be identified and segregated for billing withholding.

h. Contractor response to the assessment of a penalty by the ACO for inclusion of unallowable costs in a certified overhead cost submission pursuant to DFARS 231.7000 is a proceeding as described in 7-1918.5a. The penalty proceeding is separate from the indirect rate resolution process and proceedings. Contractors should segregate and withhold the legal and accounting costs associated with the penalty proceeding.

i. If the contractor is not segregating and withholding costs of proceedings as required by the cost principle, the auditor should attempt to persuade the contractor to comply. The ACO should be notified of such instances concerning progress payments and a DCAA Form 1 (Notice of Costs Suspended and/or Disapproved) should be prepared for disallowance or suspension of such costs included in public vouchers. The auditor should take care in the oversight of this cost area so as not to prematurely disclose the existence of a government proceeding to the contractor.

7-1919 Accounting for Lump-Sum Wages Resulting from Union Contracts

7-1919.1 General

This section provides audit guidance on the proper accounting for lump-sum wage payments resulting from union contracts. Union contracts may provide that union member employees receive a lump-sum payment in lieu of or in addition to an increase in their base wage rate. The specific terms of lump-sum payments may vary, but ordinarily the employee is not required to refund to the company any portion of the payment if the employee terminates employment prior to the end of the contract period.

7-1919.2 Future Benefit of Lump-Sum Payments

a. Neither the FAR, CAS, or Statements of Financial Accounting Standards (FAS) provide specific guidance on the accounting of lump-sum wages. The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) released Issue Summary (EITFIS) No. 88-23 dated December 1988, "Lump-Sum Payments Under Union Contracts" which provides specific guidance regarding the accounting for lump-sum payments. In the absence of specific guidance in the FAR, CAS, or FAS, the EITFIS which interprets GAAP is the appropriate accounting guidance to follow.

b. EITFIS 88-23 concludes that lump-sum payments are similar to an intangible asset in that the payments provided to the individuals in the current period will benefit future periods in the form of reduced payroll expense. In addition, the EITFIS 88-23 notes that Accounting Principles Board (APB) Opinion No. 12 requires that amounts estimated to be paid under deferred compensation contracts with employees be accrued in a systematic and rational manner over the period of active employment beginning at the time the union contract is entered into. Although the lump-sum payments are generally made at the beginning of each year, they should receive similar treatment so that the expense is recog-

nized in a systematic and rational manner. EITFIS 88-23 concludes that since the current lump-sum payments clearly benefit future periods, the matching concept requires that they be deferred and amortized over the period benefited; e.g., the period covered by the union contract.

7-1919.3 Multiple Lump-Sum Payments

EITFIS 88-23 addresses a single lump-sum payment. What happens when the union contract requires multiple lump-sum payments to be made over the period of the union contract? Discussions with the FASB staff led to the conclusion that each payment should be amortized from the scheduled date of payment to the date of the next scheduled payment. For example, if the union contract requires three lump-sum payments to be made on 1 October 1990, 1991, and 1992, with the contract expiring on 30 September 1993, then the costs of the 1 October 1990 payment should be amortized from 1 October 1990 to 30 September 1991, the 1 October 1991 payment from 1 October 1991 to 30 September 1992, and the 1 October 1992 payment from 1 October 1992 to 30 September 1993.

7-1919.4 Effect of Delay in Union Contract Execution

a. A union contract may not be signed until some time after the previous contract has expired. Generally, the new contract will be retroactive, with an effective date coinciding with the expiration date of the prior contract. In such cases, the employees will usually receive a lump-sum payment on the date the contract is signed, although the period covered by the contract begins some time earlier. The matching principles discussed in the previous paragraphs should also apply here; i.e., the lump-sum payments should be amortized over the period of the union contract. The question is whether the amortization period begins at the time the contract is executed or at the time it is effective. The key to answering this question is determining the time at which the liability constructively exists.

b. Statement of Financial Accounting Concepts (SFAC) No. 6 defines liabilities

as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." When employees continue to work after the old union contract expires in anticipation of a new contract, the act of continuing to work may constitute the past event referenced in the SFAC. In some circumstances, by continuing to work, the employees are showing that they anticipate receiving some future benefit. Under these circumstances, it would be difficult for the contractor to avoid making payments (a future transfer of assets) to these employees, either in the form of lump-sum payments, cost of living adjustments, or other benefits. Finally, the probable future sacrifice of benefits would be the lump-sum payments, provided it can be reasonably forecasted that these payments will be included in the new union contract. Therefore, if it can be reasonably forecasted that the payments will be made, then the costs should be amortized over the union contract period beginning on the effective date of the contract. Conversely, if it can be shown that future payments are not probable (e.g., lump-sum payments are not included in the union labor package, lump-sum payments are in dispute, or the union negotiating position includes elimination of the lump-sum payments), then a liability does not exist until the union contract is signed. Thus, if these conditions have been met, the lump-sum payments should be amortized over the period covering the date of contract execution through the date of contract expiration (or the date of the next scheduled payment in the case of multiple payments). The key factor is to determine if there was a prior expectation that the lump-sum payments would be included in the new union contract.

7-1919.5 Accounting Change

For those contractors whose accounting practice is to accrue the payments in advance or to expense the lump-sum when paid, a change from the current method to amortization over the union contract period constitutes a change in

the method of assigning costs to cost accounting periods. The contractor is subject to the requirements of FAR 52.230-5, Administration of Cost Accounting Standards, including the preparation of a cost impact proposal for those contracts that contain this clause.

7-1920 Environmental Costs

7-1920.1 Summary

Environmental costs are normal costs of doing business and are generally allowable costs if reasonable and allocable. Some environmental costs must be capitalized when the incurrence of such costs improves the property beyond its acquisition condition or under certain circumstances when the costs are part of the preparation of the property for sale. If environmental clean-up efforts resulted from contamination caused by contractor wrongdoing, the clean-up costs are not allowable. Environmental costs may be subject to future recoveries from insurance companies and other sources, which may not be reasonably predictable at the time the environmental clean-up costs are paid. Some of the sources of recovery may be unknown when the contractor pays for environmental clean-up costs. As such, clean-up costs claimed or forecasted are usually not reflective of the contractor's ultimate liability for the costs. Therefore, the forecasted costs should be treated as contingent costs subject to FAR 31.205-7, Contingencies. Also, any otherwise allowable incurred environmental clean-up costs should be accepted contingent upon the government sharing in any future recoveries from insurance policies or other sources. Advance agreements should be recommended to protect the government's interests in any future recoveries of clean-up costs reimbursed by the government.

7-1920.2 Types of Environmental Costs

Environmental costs include costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs. Costs associated with fault-based liabilities to

third parties are not environmental costs (see 7-1920.12).

7-1920.3 Cost Principles Applicable to Environmental Costs

The costs incurred to clean up environmental contamination are considered to be normal business expenses. The primary cost principles applicable to environmental costs are FAR Subsections: 31.201-2, Allowability; 31.201-3, Reasonableness; and 31.201-4, Allocability. Other cost principles applicable in specific circumstances include FAR Subsections: 31.201-5, Credits; 31.205-3, Bad Debts; 31.205-7, Contingencies; 31.205-15, Fines, Penalties, and Mischarging Costs; and 31.205-47, Costs Related to Legal and Other Proceedings.

7-1920.4 Normal Business Expense

Normal business expenses are those expenses that an ordinary, reasonable, prudent businessperson would incur in the course of conducting a competitive for-profit enterprise. In the context of environmental costs, normal business expenses are measured by the actual costs incurred in the period. Not all normal business expenses are allowable for government contract costing purposes. To be allowable, costs must also be reasonable in amount, allocable to government contracts, and not be specifically unallowable under government cost principle provisions.

7-1920.5 Reasonableness of Environmental Costs

a. The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of an ordinary, reasonable, prudent businessperson performing non-government contracts in a competitive marketplace. A government contractor should take measures to prevent or reduce contamination which a prudent businessperson would pursue to reduce its environmental costs.

b. Determination of reasonableness of clean-up costs also requires an examination of the circumstances of the contaminating events. Contractors should not be

reimbursed for increased costs incurred in the clean-up of contamination which they should have avoided. In order to be allowable, contamination must have occurred despite due care to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to contractor delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should be net of reasonably available recoveries from insurance which would offset the clean-up costs.

7-1920.6 Allocability of Environmental Costs

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. Costs to clean up environmental contamination caused in prior years will generally be period costs allocated through a company's G&A expense pool. Clean-up costs incurred at a home-office, group-office, or other corporate-office level should be allocated to the segment(s) associated with the contamination for inclusion as part of the segment's G&A cost. Clean-up costs incurred by a segment should be allocated through its G&A expense pool if no other segments were associated with the contamination. If other segments participated in the contamination, a fair share of the clean-up costs should be allocated to the other segments for inclusion in their G&A expense pool. This is in accordance with CAS 403 and 410 for CAS-covered contractors.

7-1920.7 Environmental Costs Related to Previous Sites and Closed Segments

a. If costs arise from a site the contractor segment previously occupied, the costs for clean-up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. There are many possible variations for the cost accounting treatment of environmental costs for a closed segment, depending on the facts of the particular

situation. Information auditors should consider includes:

(1) Are any aspects of the closed segment's business being continued by the remaining segments?

(2) Is the site still owned by the contractor? If it is, what is its current use?

(3) If the site is not currently owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental clean-up liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

b. Each closed segment case must be reviewed based on its own facts to determine if the costs incurred for the closed segment should be directly allocated to other segments, be allocated as residual home office costs, or be treated as an adjustment of costs associated with the closing of the segment.

7-1920.8 Capitalization of Environmental Costs

a. Generally Accepted Accounting Principles as expressed in the Emerging Issues Task Force (EITF) Issue No. 90-8 indicate that environmental costs would normally be expensed in the period incurred unless the costs constitute a betterment or an improvement, or were for fixing up property held for sale. Betterments and improvements which exceed the contractor's capitalization threshold must be capitalized. Costs of fixing up a property for sale are generally considered to be part of the sales transaction, if realizable from the sale.

b. It would be unreasonable for the government to accept as current period costs expenditures which increase the value of contractor assets; accordingly, these costs should be capitalized for government contract costing purposes.

c. The EITF discusses the following situations where capitalization of the expenditures may be appropriate:

(1) Costs incurred to clean-up a site. These costs should be capitalized if the clean-up effort improves the property beyond the original condition of the property at acquisition. The costs incurred to restore a property to its acquisition condition are generally expensed

unless they extend the property's useful life.

(2) Costs incurred to fix up property held for sale. These costs are to be capitalized, if they are realizable from the sale. A contractor may be required to incur contamination clean-up costs far in excess of any amount reasonably realizable upon sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition.

(3) Costs incurred to prevent future contamination. These costs would have an economic value in more than one period and should be amortized over their useful life. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404 and GAAP.

d. Examples of capitalization of environmental costs:

(1) A contractor acquires property which was contaminated by a previous owner. Clean-up costs are capitalized as an improvement. Costs of ground and water clean-ups are increases to the book value of the land.

(2) A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs.

(3) A contractor incurs \$80 million to clean up contamination it caused at a site which has a book value of \$100 million and which is being held for sale at a price of \$500 million. The \$80 million is realizable from the sale and therefore, should be capitalized. If the sales price were \$100 million instead, none of the \$80 million would be realizable and it should be expensed in the period.

(4) The clean-up in example (3) is related to contamination existing at acquisition. In this situation, the \$80 million would be capitalized even for the sale at a price of \$100 million and would produce an \$80 million loss on the sale. In effect, this would recognize that the contractor overpaid for the land at the time of acquisition.

7-1920.9 Potentially Responsible Party (PRP) for Environmental Clean-Up

a. The environmental laws usually require each Potentially Responsible Party (PRP) for contamination at a site to be individually liable for the complete clean-up of the site. The allowable environmental cost should only include the contractor's share of the clean-up costs based on the actual percentage of the contamination attributable to the contractor.

b. Contractors with the ability to pay will be required to fund clean-up efforts for sites where they are named as PRPs. If the government accepted contractor costs on an ability to make payment basis, a government contractor could end up billing a disproportionate share of a site's clean-up costs to government contracts instead of recovering the excess payments from other PRPs.

7-1920.10 Environmental Bad Debts of Other PRPs

a. When a contractor pays for more than its share of the site clean-up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean-up effort. If a contractor pays out more than its share of clean-up costs, it is up to that contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

b. If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are, in their essential nature, bad debts. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.205-3 and 31.204(c)). However, see c. below for the exception to this guidance.

c. The guidance under a. and b. above does not apply in situations when all of the following three conditions are met: (1) a contractor is legally required to pay another PRP's share of the clean-up costs, (2) that PRP is out of business, and (3) there is no successor company having assumed that PRP's liabilities. When these three conditions are met, the clean-up costs which are attributable to the other PRP's contamination should not be

disallowed as bad debt type expenses since there is no one against whom the contractor can take recovery action.

7-1920.11 Insurance Recovery for Environmental Costs

a. The insurance industry does not currently consider environmental contamination an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

b. Some courts have found that policies written before the insurance industry began to specifically exclude environmental coverage do afford coverage for environmental damages. Any insurance recoveries for a contamination clean-up will be applied as credits against any costs which were or would be otherwise allowable for that clean-up effort.

c. Many environmental contamination events now generating costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. It is the earlier insurance policies which are the source of the potential claims. Most insurance companies are contesting the claims and when payments are made, they are based on partial settlements or are made after lengthy legal battles. When a claim is possible and economically feasible, the contractor should pursue it.

d. The auditor should inquire about the existence of environment contamination policies and comprehensive general liability policies which do not contain environmental clean-up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for government contracts.

e. The contractor's support for proposed clean-up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims for contract costing is a potential subject for negotiation

which should be addressed by the auditor and ACO (see 7-1920.15b).

7-1920.12 Fault-Based Liabilities to Third Parties

a. Examples of liabilities to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third-party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a government contract. Such costs are not environmental costs.

b. In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are nonetheless based on those or other fault-based legal theories.

7-1920.13 Environmental Wrongdoing

a. If environmental clean-up costs are the result of contractor violation of laws, regulations, orders or permits, or disregard of warnings for potential contamination, the clean-up costs including any associated costs, such as legal costs, would be unreasonable and thus unallowable.

b. Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. However, the incurrence of clean-up costs to correct environmental contamination is not a penalty; it is a legal obligation.

c. Most environmental laws do not require the contractor to be guilty of a violation to enforce contractor payment for clean-up costs. Therefore, it is rare for government agencies to bring criminal, or even administrative, charges for contamination. Auditors should request the contractors to provide documents sufficient to allow a determination as to how the contamination occurred. The Environmental Protection Agency, in designating a company as a Potentially Responsible Party (PRP), will normally provide a written rationale as to how the company contributed to the contamination at a site.

d. For purposes of disallowing the costs, the government must show that the preponderance of the evidence supports the position that the contractor violated the law, regulation, order or permit, or the contractor disregarded warnings for potential contamination. That is, it must be more likely that the government's allegation of wrongdoing is correct than that it is not.

e. The contractor should not be denied recovery of clean-up costs, if it complied with the laws, regulations, and permits in effect at the time of the contamination.

7-1920.14 Contingent Nature of Environmental Costs

a. Ideally, the government wants to negotiate contract prices based on the net environmental costs after recovery of insurance claims and any amounts owed by later-discovered PRPs. At the time that environmental costs are being incurred, it may not be possible to reasonably estimate what the net costs will ultimately be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty.

b. Because of the uncertainty of the cost projections and of future recoveries from the insurance companies, as well as the difficulty in identifying all the other PRPs, both forecasted and incurred environmental clean-up costs and related legal costs that are allowable should be accepted contingent upon the government participating in any insurance recoveries or the identification of other PRPs at a later date. See 7-1920.15.

7-1920.15 Advance Agreements for Environmental Costs

a. There are many areas of judgment involved in the determination of allowability for environmental costs. It is necessary for the auditor and the ACO to coordinate closely during the review. Advance agreements should be considered to facilitate negotiations with the contractor.

b. Acceptance of the costs may require some form of agreement to protect the government's interest. Any agreement to

7-1920.15b.

accept costs for clean-ups or for the costs of pursuing insurance recoveries should also provide expressly for government participation in any insurance claim recoveries and any reductions resulting from later-discovered PRPs. Consideration should also be given to requiring contractor diligence in pursuing insurance recoveries and identifying contamination attributable to other PRPs. Advance agreements should provide for recovery of expenses priced into fixed price contracts if those expenses are later reduced based on subsequent identification of additional PRPs or insurance coverage after the agreement on price.

7-1920.16 Environmental Clean-Up Trust Funds

a. Making payments for clean-up efforts through a trust fund is a device for the administrative and the financing convenience of the PRPs named at a given site. The allowability of costs on government contracts should be based on the contractor's allocable share of the actual clean-up obligations. Contractor payments into a fund before clean-up costs are incurred are not an expense to the contractor until actual costs have been incurred for the site clean-up work. The excess or early payments are prepaid expenses.

b. It is the contractor's responsibility to support its claimed costs as allowable contract costs. Before accepting the contributions made to a trust fund as contract costs, auditors should obtain and evaluate sufficient supporting data to determine the allowability and the actual payment of the claimed costs. When the claimed "trust fund" costs are significant, the contractor should be requested, as part of its cost support, to arrange for government audit access to the accounting records of the trust fund.

7-1921 Domestic and Foreign Tax Differential Allowances

Tax differential allowances represent employee compensation for additional Federal, state, local, or foreign income taxes resulting from domestic or foreign assignments.

7-1921.1 FAR Applicability

a. Under FAR 31.205-6(e), differential tax allowances for foreign assignments are unallowable if calculated directly on the basis of an employee's specific increase in income taxes. A specific increase is evidenced by any calculation that considers the employee's specific income tax liability, regardless of whether the calculation is made before or after the employee's actual taxes are known.

b. FAR 31.205-6(e) disallows any differential tax allowances for domestic assignments.

7-1921.2 Allowable Foreign Tax Differential Allowances

a. A foreign tax differential complies with the FAR provision if it is a fixed payment to all employees on foreign assignment, such as a \$3,000 annual payment, or if it is computed based on a percentage, such as 15 percent of all other foreign differential pay allowances.

b. Separate foreign tax differentials based on marital status and/or number of dependents comply with the FAR provision. An example would be a payment of 15 percent of the total amount of differential pay for all married employees and 10 percent for all single employees. Another example would be a differential of \$3,000 for all employees, with an additional \$500 for each dependent.

7-1921.3 Unallowable Foreign Tax Differential Allowances

a. Foreign tax differentials based on the specific tax liability of a specific employee do not comply with the FAR provision. For example, assume an employee has an estimated (or actual) tax liability of \$5,000. Further assume that it is estimated that the tax liability would have been \$3,000 had the employee remained on domestic assignment. As a result, the employee receives a tax differential of \$2,000. This amount was computed based on the employee's specific tax liability and is therefore unallowable.

b. Foreign tax differentials based on the increase in the tax rate for a specific employee or employees do not comply with the FAR provision. For example, assume that there are three employees,

each of whom is single with no dependents. However, because of differing investment income and/or itemized deductions, each employee has a different increase in his/her tax rate as a result of the foreign assignment. If the contractor computes the tax differential payments using 10 percent for Employee A, 12 percent for Employee B, and 14 percent for Employee C, the payments would be unallowable, since they are computed based on specific tax liabilities of specific employees.

7-1922 Mentor-Protege Program Costs

7-1922.1 General

a. The Mentor-Protege Program is a socio-economic program to aid small, disadvantaged businesses. It teams a well-established DoD contractor with one of its small, disadvantaged subcontractors to provide the small business with training and guidance in the art of running a successful business. DoD contractors may participate in the program during the period from 1 October 1991 to 30 September 1999.

b. Mentor-Protege Program costs are generally costs for developmental assistance that are in excess of the costs the prime contractor would normally incur in the administration of its subcontracts with small businesses. The costs can be internal costs of the mentor firm incurred to provide assistance using its own personnel or costs paid to third-party assistance providers that qualify under DFARS 219.7104(a)(2).

7-1922.2 Mentor-Protege Program Cost Classification

a. Depending upon the circumstances, Mentor-Protege Program costs may be classified as either direct or indirect costs.

b. Mentor-Protege Program costs will be classified as direct contract costs when the mentor-protege arrangement is included as a separately priced line item of a contract or when DoD has awarded a separate contract solely for the mentor-protege arrangement.

c. Mentor-Protege Program costs will be classified as indirect costs if there is no specific contractual requirement provided. Such costs should be allocated using the method normally used by the contractor to allocate indirect subcontract administration expenses.

7-1922.3 Allowability of Mentor-Protege Costs

a. Normal subcontract administration costs are allowable in accordance with the prime contractor's disclosed or established practices. Costs incurred in excess of normal subcontract administration costs, for the purposes set forth in DFARS 219.71, are allowable if the costs are:

- (1) incurred in accordance with a DoD-approved mentor-protege arrangement;
- (2) incurred prior to 1 October 1996 (costs incurred from 1 October 1996 until 30 September 1999 are only eligible for the credits discussed in 7-1922.5);
- (3) incurred by using mentor firm personnel to provide direct assistance to the protege firm or by the mentor firm paying an approved outside provider of assistance; and
- (4) otherwise reasonable, allocable, and allowable.

b. Mentor firms are urged to reach advance agreements with ACOs on the allowability of costs under an approved Mentor-Protege Program arrangement.

7-1922.4 Mentor-Protege Program Impact on Subcontract Awards

The mentor firm may award subcontracts noncompetitively to the protege firm as part of an approved arrangement. The Office of Small and Disadvantaged Business Utilization, Office of the Under Secretary of Defense for Acquisition (OUSD(A)SADBU) is responsible for approving mentor-protege agreements. Also, special advance payment and progress payment methods are available to pay the protege subcontractor under DFARS 219.7105.

7-1922.5 Mentor-Protege Program Credits Against Small, Disadvantaged Business Subcontracting Goals

a. The Mentor-Protege Program provides another incentive to mentor firms

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for participation in the program. Besides reimbursement of costs as previously discussed, the program also provides for credits toward subcontracting goals. The cost of any developmental assistance which is not reimbursed to the mentor firm as a direct or indirect contract cost is administratively applied toward the attainment of the mentor firm's Small and Disadvantaged Business Subcontracting Goals negotiated pursuant to FAR Subpart 19.7. Such costs are credited toward the subcontracting goals at the following multiples of the costs incurred:

(1) Four times the total amount of developmental assistance costs defined in DFARS 219.7104(a)(2);

(2) Three times the total amount of developmental assistance costs defined in DFARS 219.7104(a)(1)(i) through (vi); and

(3) Two times the total amount of other developmental assistance costs, as defined in DFARS 219.7104(a)(1)(vii).

b. When requested by the contracting officer, the auditor should verify that amounts claimed as subcontracting plan credits represent eligible costs and are properly classified for purposes of the credit calculations.

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CHAPTER 8

8-000 COST ACCOUNTING STANDARDS

8-001 Scope of Chapter

This chapter presents guidance for implementing DCAA responsibilities in

connection with the Cost Accounting Standards Board's (CASB) Rules, Regulations, and Standards.

8-100 Section 1 — Overview of Cost Accounting Standards and Rules and Regulations

8-101 Introduction

This section provides the legal background and purposes of implementing the Cost Accounting Standards, including the rules and regulations, and audit responsibilities in implementing Section 26 of the Federal Procurement Policy Act, Public Law 100-679 (41 U.S.C. 422).

8-102 Background

8-102.1 Establishment of Cost Accounting Standards Board (CASB)

The CASB was established in 1970 as an agency of Congress in accordance with a provision of Public Law 91-379. It was authorized to (1) promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts in excess of \$100,000 and (2) establish regulations to require defense contractors and subcontractors, as a condition of contracting, to disclose in writing their cost accounting practices, to follow the disclosed practices consistently and to comply with duly promulgated cost accounting standards.

8-102.2 Public Law 91-379

Public Law 91-379 provided that the official rules, regulations, and standards issued by the CASB are binding on all relevant Federal agencies, defense contractors, and subcontractors. Therefore, in pricing, administering, and settling contracts covered by this legislation, CASB promulgations must be used to

estimate, accumulate, and report the associated costs. As a matter of general policy, the CASB assigned to the contracting agencies the responsibilities of applying and implementing its rules, regulations, and standards. A "relevant Federal agency," as defined by the CASB, is "any Federal agency making a national defense procurement and any agency whose responsibilities include the review, approval, or other action affecting such a procurement." The Board defines "national defense" as "any program for military and atomic energy production or construction, military assistance to any foreign nation, stockpiling, space, and directly related activity."

8-102.3 Relevant Federal Agencies

In response to the CASB's implementation policy, the three principal relevant Federal agencies, Department of Defense (DoD), Department of Energy (DOE) and National Aeronautics and Space Administration (NASA), issued uniform regulations implementing the requirements of the CASB for applicable negotiated defense contracts. The General Services Administration (GSA) amended the Federal Procurement Regulations (FPR) to extend the applicability of the CASB's rules, regulations, and standards to most negotiated nondefense as well as defense contracts.

8-102.4 CASB's Establishment of Rules and Regulations

a. The CASB's first major promulgations, which became effective on 1 July 1972, established (1) the rules and regula-

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tions to be followed by the acquisition agencies, (2) the contract clause to be included in all covered contracts, (3) the Disclosure Statement format to be used by contractors and subcontractors, (4) definitions of various terms used in the CASB's promulgation, and (5) two standards.

b. The CASB promulgated 17 more standards before going out of existence in late 1980.

8-102.5 CAS Working Group

a. To interpret the CASB rules and regulations for implementing in DoD procurement practices, DoD established in 1976 a CAS Steering Committee and Working Group. During its existence, the CAS Working Group issued a number of Interim Guidance Papers on a variety of subjects, most of which are still effective and have been incorporated into this chapter. The Interim Guidance Papers were approved by the Office of the Secretary of Defense (R&E) and given wide distribution.

b. The papers issued by the CAS Working Group that are still effective are listed below. The full text of the papers can be found in the CCH CAS Guide:

No.	Subject
76-2	Administration of Cost Accounting Standards
76-3	Policy for Application of CAS to Subcontracts
76-4	Determining Increased Costs to the Government for CAS Covered FFP Contracts
76-5	Treatment of Implementation Costs Related to Changes in Cost Accounting Practices
76-6	Application of CAS Clause to Changes in Contractor's Established Practices when a Disclosure Statement has been Submitted
76-7	Significance of "Effective" and "Applicability" Dates Included in CAS
76-8	Use of the Offset Principle in Contract Price Adjustments Resulting from Accounting Changes
76-9	Measurement of Cost Impact on FFP Contracts

77-10	Retroactive Implementation of CAS When Timely Compliance is Not Feasible
77-13	Applicability of CAS 405 to Costs Determined to be Unallowable on the Basis of Allocability
77-15	Influence of CAS Regulations on Contract Terminations
77-16	Applicability of CAS to Letter Contracts
77-17	Identification of CAS Contract Universe at a Contractor's Plant
77-18	Implementation of CAS 414 - Cost of Money as an Element of the Cost of Facilities Capital; and DPC 76-3
77-19	Administration of Leased Facilities Under CAS 414
77-20	Policy for Withdrawing Adequacy Determination of Disclosure Statement
78-21	Implementation of CAS 410, Allocation of Business Unit G&A Expenses to Final Cost Objectives
78-22	CAS 409 and the Development of Asset Service Lives
78-23	Administration of Equitable Adjustments for Accounting Changes not Required by New Cost Accounting Standards
79-24	Allocation of Business Unit G&A Expense to Facilities Contracts
81-25	Change in Cost Accounting Practice for State Income and Franchise Taxes as a Result of Change in Method of Reporting Income from Long Term Contracts

8-102.6 Current Status of CAS

a. The CASB went out of existence on 30 September 1980 as a result of Congress' decision not to provide additional funding. However, the rules, regulations, and standards issued by the CASB during its tenure continue to have the effect of law.

b. In December 1988, Congress passed legislation to reestablish the CASB. The new CASB is located in the Office of Federal Procurement Policy (OFPP) which is under the Office of Management and Budget (OMB). The CASB consists

of five members: the Administrator of OFPP who is the Chairman and one member each from DoD, GSA, industry and the private sector (generally expected to be from the accounting profession).

c. Cost accounting standards promulgated by the CASB will be applicable to all negotiated prime contract and subcontract procurements within the United States in excess of \$500,000. Exemptions in the current CAS for established catalog or market prices and prices set by law or regulation continue. The legislation also states that the CASB will have the authority to exempt classes or categories of contractors and subcontractors from the CAS requirements and to establish procedures for waivers.

d. The legislation continues the requirement for contractors to disclose in writing their cost accounting practices and to agree to a contract price adjustment, with interest in accordance with section 6621 of the Internal Revenue Code of 1986, 26 U.S.C. 6621, for any increased costs paid by the United States as a result of a change in a contractor's or subcontractor's cost accounting system or a failure by a contractor or subcontractor to comply with applicable cost accounting standards.

e. On 17 April 1992, the CASB recodified at 48 CFR Chapter 99, the CASB's Rules and Regulations previously found at both FAR Part 30 and 4 CFR Parts 331 through 420. The recodification, which is administrative in nature, brings the CAS in compliance with Public Law 100-769. FAR Part 30 was revised on 31 August 1992 (FAC 90-12) to describe the policies and procedures for applying the CASB rules and regulations at 48 CFR Chapter 99.

f. Contractors performing under existing CAS covered contracts shall be subject to continuous CAS coverage. Contractors not previously subject to CAS would be subject to modified coverage (CAS 401 and 402) after receipt of a single CAS covered contract unless the contract award exceeds \$10 million. In that instance, the contractor would be subject to full CAS coverage. For contractors that become subject to full CAS coverage, CAS 401, 402, 405 and 414 are applicable after receipt of the first con-

tract containing the full CAS coverage clause. CAS 418 and 420 are applicable beginning with the second full fiscal year after receipt of the first contract containing the full CAS coverage clause. The remaining CAS are applicable beginning with the first full fiscal year after receipt of the first contract containing the full CAS coverage clause.

8-103 CAS Coverage Requirements

The FAR implementing guidance and the CAS are contained in 48 CFR 9903 and 9904 and agency supplements. The following subsections contain a summary of CAS coverage requirements.

8-103.1 Exemptions

The following categories of contracts and subcontracts are exempt from all CAS requirements (48 CFR 9903.201-1):

a. Sealed bid contracts.

b. Negotiated contracts and subcontracts not in excess of \$100,000.

c. Contracts and subcontracts with small businesses. FAR Subpart 19.3 addresses determination of status as a small business. A small business (offeror) is one which represents, through a written self-certification, that it is a small business concern in connection with a specific solicitation and has not been determined by the Small Business Administration (SBA) to be other than a small business. The contracting officer accepts an offeror's representation unless that representation is challenged or questioned. If the status is challenged, the SBA will evaluate the status of the concern and make a determination. (Specific standards appear in Part 121 of Title 13 of the Code of Federal Regulations.)

d. Contracts and subcontracts with foreign governments or their agents or instrumentalities or, insofar as the requirements of CAS other than CAS 401 and 402 are concerned, any contract or subcontract awarded to a foreign concern.

e. Contracts and subcontracts in which the price is set by law or regulation.

f. Contracts and subcontracts in which the price is based on established catalog or market prices.

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g. Contracts and subcontracts of \$500,000 or less if the business unit is not currently performing any national defense CAS-covered contracts. Once a contract in excess of \$500,000 is awarded, subsequent negotiated awards in excess of \$100,000 will be CAS-covered.

h. Nondefense contracts awarded based on adequate price competition.

i. Nondefense contracts and subcontracts awarded to business units that are not currently performing any CAS-covered national defense contracts.

j. Contracts and subcontracts with educational institutions other than those to be performed by federally funded research and development centers operated by such institutions.

k. Contracts awarded to labor surplus area concerns pursuant to a labor surplus area set-aside.

l. Contracts and subcontracts awarded to a United Kingdom contractor for performance substantially in the United Kingdom, provided that the contractor has filed with the United Kingdom Ministry of Defense a completed Disclosure Statement which shall adequately describe its cost accounting practices.

m. Subcontracts under the NATO PHM Ship program to be performed outside the United States by a foreign concern.

n. Contracts and subcontracts to be executed and performed entirely outside the United States, its territories, and possessions.

o. Firm fixed price contracts and subcontracts awarded without submission of any cost data; provided, that the failure to submit such data is not attributable to a waiver of the requirement for certified cost or pricing data.

8-103.2 Types of Coverage

a. Full coverage requires that the business unit comply with all of the CAS in effect on the contract award date and with any CAS that become applicable because of new standards (CAS clause at FAR 52.230-2). Full coverage applies to contractor business units that:

(1) Received a single national defense CAS-covered contract award of \$10 million or more;

(2) Received \$10 million or more in national defense CAS-covered contract awards during its preceding cost accounting period; or

(3) Received less than \$10 million in national defense CAS-covered contract awards during its preceding cost accounting period but such awards were 10 percent or more of total sales.

b. Modified CAS coverage requires only that the contractor comply with CAS 401 and 402 (CAS clause at FAR 52.230-3). Modified CAS applies where the contractor received less than \$10 million in national defense CAS-covered contract awards during its preceding cost accounting period and such awards were less than 10 percent of total sales.

c. Nondefense contracts subject to CAS shall have the same CAS-coverage as the most recently awarded national defense contract currently being performed.

d. Subcontract awards subject to CAS require the same CAS-coverage as would prime contracts awarded to the same business unit.

8-103.3 Effect of Contract Modifications

Contract modifications made under the terms and conditions of the contract do not affect its status with respect to CAS applicability. Therefore, if CAS was applicable to the basic contract, it will apply to the modification. Conversely, if the basic contract was exempt from CAS, the modification will also be exempt regardless of the amount of the modification. However, if the contract modification adds new work it must be treated for CAS purposes as if it were a new contract. In this case, if the modification exceeds the threshold, it will be CAS-covered. (See CAS Working Group Paper 76-2.)

8-103.4 Effect of Basic Ordering Agreements

Basic agreements and basic ordering agreements (BOAs) are not considered contracts (FAR 16.702(a) and 16-703(a)). Since orders must be considered individually in determining CAS applicability, only orders which exceed the threshold will be CAS-covered. (See CAS Working Group Paper 76-2.)

8-103.5 Effect of Letter Contracts

CAS is applicable to letter contracts exceeding the threshold as of the date of the award. Definitizing the contract will not activate any new standards since definitization is a contract modification rather than a new contract. (See CAS Working Group Paper 77-16.)

8-103.6 CAS Flowdown Clause — FAR 52.230-2

The CAS flowdown clause in prime contracts (and upper-tier subcontracts) requires subcontractors to comply with FAR 52.230-2(d), that is, any standards in effect at the time the subcontract is awarded plus any new standards which become applicable to the subcontractor. (See CAS Working Group Paper 76-3.)

8-103.7 Submission of Disclosure Statement

The requirements for submission of a Disclosure Statement were phased in gradually by the CASB and the current requirements (48 CFR 9903.202-1(b)) are:

- a. Any business unit that is selected to receive a CAS-covered negotiated national defense contract or subcontract of \$10 million or more; or
- b. Any company which, together with its segments, received net awards of negotiated national defense prime contracts and subcontracts subject to CAS totaling more than \$10 million in its most recent cost accounting period.

8-103.8 Additional Exemptions on a Particular Standard

Subparagraph .70 of each cost accounting standard will provide for any additional exemptions associated with a particular standard.

8-104 Audit Responsibility**8-104.1 Basic Functions**

FAR 30.202-6, -7, and 30.602 outlines the basic functions of the contract auditor in the implementation of the standards. It provides that the contract auditor shall be responsible for making recommendations to the ACO as to whether:

a. a contractor's Disclosure Statement, submitted as a condition of contracting, adequately describes the actual or proposed cost accounting practices as required by 41 U.S.C. 422 as implemented by the CASB;

b. a contractor's disclosed cost accounting practices are in compliance with FAR Part 31/DFARS Part 231 and applicable cost accounting standards;

c. a contractor's or subcontractor's failure to comply with applicable cost accounting standards or to follow consistently its disclosed cost accounting practices has resulted, or may result, in any increased cost paid by the government; and

d. a contractor's or subcontractor's proposed price changes, submitted as a result of changes made to previously disclosed or established cost accounting practices, are fair and reasonable.

8-104.2 Auditor's Function on Subcontracts Subject to CAS

As specifically related to subcontracts subject to CAS, the contract auditor's functions tend to fall into the following areas:

a. The auditor will review the books and records of prime contractors and higher tier subcontractors to determine that they are including the CAS clauses (FAR 52.230-2 or 52.230-3, as applicable, and FAR 52.230-5) in awarded subcontracts and that either subcontractor Disclosure Statements or certificates of monetary exemption have been obtained.

b. 48 CFR 9903.202-8(a) and 42.204(b) provide that the company awarding the CAS-covered subcontract is responsible, except as noted in c. and d. below, for securing subcontractor compliance with CASB rules, regulations, and standards. Notwithstanding these FAR provisions, in most cases compliance reviews of CAS-covered subcontracts will be performed by the auditor cognizant of the subcontractor in conjunction with the performance of other regularly scheduled audit assignments. Where DCAA audits a prime contractor who also holds covered subcontracts, the auditor should routinely include the subcontracts in the CAS-covered reviews. Even though the audit responsibility may not have been formal-

¶8-104.2b.

ly assigned, the auditor, to protect the government's interest, must consider all covered work held by the contractor when making CAS-related reviews. At locations where no government prime contracts exist, the auditor should attempt to identify the existence of CAS-covered subcontracts either during the performance of regular ongoing audit reviews or through routine examinations of existing acquisition records. Once identified, these subcontracts will also be subject to audit tests for CAS compliance.

c. Under the provisions of 48 CFR 9903.202-8(b) a subcontractor may satisfy disclosure requirements by identifying to the prime contractor the ACO to whom its Disclosure Statement was previously submitted. 48 CFR 9903.202-8(c)(1) provides that the subcontractor may submit a Disclosure Statement that contains privileged and confidential information directly to the subcontractor's cognizant ACO. In this case a preaward determination of adequacy is not required. Instead, the cognizant ACO will advise the auditor to perform postaward reviews of adequacy and compliance.

d. Subcontractors not subject to Disclosure Statement requirements may claim that other reviews by prime contractors would jeopardize their proprietary data or competitive position. In such cases, the prime contractor's cognizant ACO in accordance with 48 CFR 9903.202-8(c)(2) will determine that it is impractical for the prime contractor to perform the reviews.

8-104.3 Contract Audit Coordinator (CAC)

The CAC will be responsible for assuring, for all organizational units of the assigned company, that consistent and compatible audit conclusions are reached by all FAOs involved. Specific responsibilities for all auditors in the coordination process are in subsequent sections of this chapter. If a CAC has not been assigned to a multidivisional contractor, the regional director cognizant of the corporate home office will designate a Corporate Home Office Auditor (CHOA) or Group Audit Coordinator (GAC), as applicable. (See also 8-204 for audit coordination within multiorganizational companies.)

8-200 Section 2 — Audits of Disclosure Statements for Adequacy**8-201 Introduction**

This section contains guidance on auditing Disclosure Statements. The audit is to ascertain whether a Disclosure Statement adequately describes the cost accounting practices to be used by a contractor for estimating, accumulating and reporting contract costs.

8-202 General

a. Defense contractors and subcontractors meeting certain criteria are required, as a condition of contracting, to disclose in writing their cost accounting practices. The Disclosure Statement has been designed to provide an authoritative description of the contractor's cost accounting practices to be used on contracts subject to the CASB rules, regulations, and standards for those contractors required to file. The more important objectives of the disclosure requirement include: (1) establishing a clear understanding of the cost accounting practices the contractor intends to follow, (2) defining costs charged directly to contracts and disclosing the methods used to make such charges, and (3) delineating the contractor's methods of distinguishing direct costs from indirect costs and the basis for allocating indirect costs to contracts. An adequate Disclosure Statement should minimize future controversies between contracting parties regarding whether the contractor has consistently followed the disclosed practices.

b. FAR 30.202-7 states that the auditor is to advise the ACO on the adequacy of the contractor's Disclosure Statement. To meet this responsibility, the auditor will audit the Disclosure Statement to ascertain if it adequately describes the cost accounting practices to be used for contracts containing the CAS clause. FAR 30.202-7(a) states that a Disclosure Statement is adequate if it is current, accurate, and complete.

c. When an ACO determines that the contractor's Disclosure Statement is adequate, it does not necessarily indicate that the ACO is certifying that all cost

accounting practices have been disclosed. It does indicate that those practices disclosed have been adequately described and the ACO currently is not aware of any additional practices that should have been disclosed. Subsequently, it may be discovered that a contractor had a cost accounting practice that was not required to be described in the Disclosure Statement. Such a practice will be considered an "established cost accounting practice," for which appropriate guidance in 48 CFR 9903.302-2 on changes and non-compliances will be followed. In addition, ACOs do have authority to withdraw an adequacy determination previously given for a Disclosure Statement. Action to withdraw the determination should not be taken unless the issue is material and the contractor will not make the revision. Contractors should be immediately advised in writing when a revision to the Disclosure Statement is necessary. (see 8-208g and CAS Working Group Papers 76-6 and 77-20.)

d. Unless permission is granted for a postaward submission, FAR 30.202-6(b) requires the ACO to determine that the offeror has made an adequate disclosure before a covered contract can be awarded to a prime contractor. Consequently, the auditor shall expedite the issuance of the reports citing inadequate conditions. To be responsive to the requirements of the acquisition offices, audit report due dates should be coordinated with the ACO. These due dates should allow the ACO enough time before contract award to (1) render a formal determination, (2) request a revised Disclosure Statement, if required, and (3) obtain audit assistance in reviewing the revised descriptions. When unforeseen circumstances delay the audit report, the ACO should be advised immediately and a revised mutually acceptable due date established. FAR 30.202-8(e) does permit postaward adequacy determinations of subcontractor Disclosure Statements. (See 8-104.2.)

e. The auditor should expedite the issuance of the audit report even when a contractor submits a Disclosure Statement well in advance of an award of a

covered contract. The lack of an imminent procurement action should not be used as the basis for extending the report due date.

f. The submission of a Disclosure Statement is required as a condition of contracting for all contractors meeting certain criteria. 48 CFR 9903.202-1(b) specifies the thresholds that contractors and subcontractors must meet to be required to file a Disclosure Statement. (See 8-103.7) FAR 52.230-1 Part I(c)(3) provides for the submission of a certificate of monetary exemption for those contractors who do not meet the current filing thresholds.

g. Contractors and subcontractors who are required to file Disclosure Statements must submit them for each organizational unit that meets either of two conditions: (1) has received or is contemplating receiving an award of a covered contract or subcontract, or (2) has had cost input or is contemplating having cost input to a covered contract or subcontract at another organizational unit within the company in the amount as prescribed in 48 CFR 9903.202-3. A single Disclosure Statement may be submitted for all organizational units within a company that have identical cost accounting practices; however, each organizational unit included in the Disclosure Statement must be identified. Corporate or group offices are required to complete Part VIII of the Disclosure Statement if their costs are allocated to one or more disclosing segments performing CAS-covered contracts or subcontracts (48 CFR 9903.202-1(d)).

h. Amendments to Disclosure Statements are required whenever the contractor changes any of its disclosed accounting practices (48 CFR 9903.202-3). For each revision of the Disclosure Statement (addition, change, or deletion), only the pages containing such revision shall be resubmitted. Detailed procedures for submitting amended Disclosure Statements have been provided in the CASB regulations. These regulations also allow agencies to prescribe criteria under which submission of a complete, updated Disclosure Statement will be required. It is important to note that the annual revision to Items 1.4.0. through 1.7.0. and

8.2.0 are not changes to accounting practices.

i. Contractors are required to submit the Disclosure Statement and any changes directly to the ACO and the cognizant auditor (48 CFR 9903.202-5). The responsibility of obtaining a proper resubmission rests with the ACO. The auditor should not consider a statement inadequate solely on questions concerning whether an amended or revised statement has been submitted in accordance with the requirements cited in paragraph h. above. However, the auditor should include in the adequacy report specific recommendations on the proper filing procedure.

j. The auditor will not distribute Disclosure Statements outside DCAA. All requests for copies of Disclosure Statements by other components of DoD or other government agencies should be referred to the ACO. Strict adherence to this requirement is critical since the CASB regulations provide that a Disclosure Statement will not be made public if the contractor files it specifically conditioned on the government's agreement to treat its contents as confidential information. Additionally, a subcontractor's Disclosure Statement will not be divulged to its prime contractor if the subcontractor makes a claim of privileged and confidential information and the prime contractor authorizes filing it directly with the government.

8-203 Proper Filing

a. After receiving a Disclosure Statement or an amendment, the auditor should ascertain if the data were filed in accordance with 48 CFR 9903.202. If the contractor has filed incorrectly (e.g., a single Disclosure Statement submitted for more than one organizational unit when the accounting practices of the organizational units are not identical) the matter should be reported immediately to the ACO. If the differences in the accounting practices among the organizational units are properly identified, the auditor should continue the adequacy review while the ACO obtains the proper submissions. If the differences are not properly identified, the auditor should

submit a report citing the inadequacy to the ACO.

b. Unless specifically requested by the ACO, no audit effort will be expended verifying the contractor's basis for filing a certificate of monetary exemption. If such a request is received, the ACO should be asked to obtain the contractor's documentation or working papers supporting the claim for a monetary exemption.

c. Obvious mistakes, such as a subsidiary filing a certificate of monetary exemption when the parent company is required to file a Disclosure Statement, should be reported to the ACO immediately.

8-204 Audit Coordination within Multiorganizational Companies

The specific responsibilities of the CAC, CHOA, GAC and the FAOs within multiorganizational companies are as follows:

a. CAC/CHOA/GAC

(1) Determine the extent of the CAC network by obtaining a list from the contractor of all organizational units which will be submitting Disclosure Statements.

(2) For all reporting organizational units, obtain from the contractor a list of the Disclosure Statement items which will be answered by the corporate office.

(3) Notify the auditors in the network of the items that will be prepared by the corporate office.

(4) Notify the auditors in the network of the date on which the corporate office Disclosure Statement is expected and establish the due date of the adequacy report.

(5) Obtain copies of all Disclosure Statements and review and compare the applicable items to assure consistency in the items answered by the home office.

(6) Distribute copies of the corporate and group office Disclosure Statements to the FAOs in the network. Notify the FAOs when changes are made to the corporate Disclosure Statement and establish the due date for the audit report on the revised statement.

(7) Establish a system to receive and distribute information within the network concerning problem areas.

(8) Conduct CAS workshops involving network auditors to assure consistency and uniformity among the various FAOs regarding the audit position for common or similar descriptions.

(9) Obtain copies of reports on all the Disclosure Statements in the network and make comparisons to assure that auditors are consistent in the treatment of common disclosures. This action should be accomplished before reports are issued.

b. FAOs

(1) Establish a target date for the issuance of audit report covering the review of the Disclosure Statements submitted by the organizational units.

(2) Inform the CAC, CHOA, or GAC of the target reporting date established in (1) above. This report due date should provide the ACO with the time needed to take appropriate action before the award of the first covered contract. The earliest report due date for an organizational unit's Disclosure Statement should become the report due date for the corporate and group office Disclosure Statement reports.

(3) Review the items prepared by the corporate office to ascertain whether the corporate office items are compatible with the described practices of the reporting organizational unit. The cognizant FAO should advise the CAC, CHOA, or GAC of any significant areas of incompatibility between the data reported by the corporate office (Part 8 of the Disclosure Statement) and the data provided by the organizational unit (Parts 1 through 7 of the Disclosure Statement).

(4) Attend the CAS workshops. (5) Plan the audit so that the audit report can be furnished to the CAC, CHOA, or GAC before it is issued to the ACO.

(6) Request assist audits of the corporate office and all intermediate organizations that perform home office functions on behalf of the operating segment involved. The assist audits should include a review of the methods used by the home office organization(s) to identify, measure, and allocate costs to segments. In most instances such reviews will be made

on an assist audit basis because the pertinent data are normally unavailable at the reporting segment level.

8-205 Audit Programs and Working Papers

a. The auditor should observe government auditing standards in preparing audit programs and working papers. Agency standard audit programs with appropriate modifications should be used where available. The audit program should be in sufficient detail to indicate the purpose of the audit step, the manner in which the work will be done, and the extent of the review. Audit programs prepared for contractors who are subject to frequent or continuous audits should require a review of data in existing files (e.g., permanent files, functional audits, estimating system surveys, price evaluations, indirect cost audits, etc.) as a major step in verifying the described cost accounting practices. For those contractors with whom DCAA has had limited or no audit experience, the potential dollar volume of covered contracts should be a major consideration in establishing the scope of the adequacy review.

b. Audit working papers should contain, at least, (1) the basis for accepting a description, (2) a record of discussions and written communications from the ACO and contractor, and (3) the auditor's rationale in resolving questionable items. The working papers should identify those descriptions accepted without audit verification. This identification is especially important for those described practices which may involve significant cost. In this way, the auditor will have a basis for identifying these practices and reviewing such items for compliance when future audits are performed.

8-206 Criteria for Adequacy Determination

a. To be considered adequate, a Disclosure Statement must be current, accurate, and complete.

(1) A Disclosure Statement is current if it describes the cost accounting practices which the contractor intends to follow for estimating, accumulating and reporting

costs associated with covered contracts. The Disclosure Statement, therefore, could possibly include practices that are currently in use; will be instituted at some future date; will be followed with the incurrence of a new cost; or a combination of these.

(a) Existing audit files should be reviewed to ascertain whether the cost accounting practices identified in the Disclosure Statement are, in fact, the contractor's current practices. For example, data in the permanent file and in recent reports on pricing proposals, functional audits, indirect cost rate proposals, and accounting system surveys cover many features of the contractor's cost accounting practices. When the adequacy review discloses a difference between a described practice and an existing practice, the auditor should discuss it with the contractor to assure that a change is intended. Conversely, if the auditor is aware of an intended change in the contractor's practice and the practice has not been described, she or he should recommend the contractor describe the intended practice as well as the existing practice.

(b) Where the contractor already has covered contracts, but was not previously required to file a Disclosure Statement, the practices subsequently described should be the same as those used to estimate and accumulate costs for the contracts entered into before the Disclosure Statement was required. If there are any known differences, a review should be scheduled to ascertain if the contractor is consistently following its established cost accounting practices that were effective when the initial covered contract was awarded or has made a change to a cost accounting practice without notifying the ACO.

(2) A Disclosure Statement is accurate if it correctly, clearly, and distinctly describes the actual method of accounting the prime contractor or subcontractor uses or intends to use on contracts subject to 41 U.S.C. 422. Vague, ambiguous, and contradictory descriptions of the contractor's cost accounting practices may hinder subsequent compliance reviews, cause disputes and litigation between contracting parties, and ultimately

result in additional cost to the government. Consequently, the auditor should carefully review the described practices for specificity and clarity. Clerical accuracy is also a requirement for the Disclosure Statement. Therefore, the auditor's review should verify whether the contractor has checked the appropriate boxes, inserted the applicable code letters, omitted any questions, etc.

To facilitate the auditor's review for accuracy, a listing of interrelationships between various sections of the Disclosure Statement is presented below:

(a) If item 1.8.0 is marked A or B, item 2.2.1 or 2.2.2 should be marked A, or item 2.5.0 should be coded C in at least one column.

(b) A response in section 2.4.0 is required only if block A of items 2.2.1 or 2.2.2 is marked.

(c) Section 2.6.0 should be completed only if one or more labor categories in item 2.5.0 were marked C.

(d) If item 2.2.2 is marked A, B, C, D, or Y, item 3.2.1 (f) must be marked with a code other than Z.

(e) If 4.1.0(a) is marked with a code other than Z, no other items in 4.1.0 are to be marked.

(f) If items 4.2.0(a), (b), (c), or (d) are marked with a code other than Z, items (e) through (n) are not to be marked.

(g) Item 3.2.3(s) must be marked other than F or Z if item 4.7.0(a) is to be marked A, B, C, or D. Item 3.2.3(k) must be marked other than F or Z if item 4.7.0(b) is to be marked A, B, C, or D. Item 2.8.0 must be marked A, B, C, D, or Y in at least one column if item 4.7.0(d) is marked A, B, C, or D.

(h) If item 4.2.0(i) is marked with a code other than Z, item 4.8.1 should be marked B or D.

(i) If item 2.5.0 is checked for A, B, C, and/or Y in any column, at least column 1 of items 6.1.1 and 6.1.2 must be completed.

(j) Item 7.1.1 cannot be blank. If item 3.2.2(d) is marked other than Z, item 7.1.1 must be marked A.

(k) Item 7.1.2 cannot be blank or marked Z in all columns if item 7.1.1 is checked A. Under ERISA, item 7.1.2 may not be checked B.

(l) Items 7.1.3, 7.1.4, 7.1.7, 7.1.8, and 7.1.9 cannot be blank in any column for which item 7.1.2 has been marked other than Z in the same column.

(m) If item 7.1.2, line C, is marked in any column, item 7.1.6 must be marked on line A, B, C, or Y in the same column.

(n) If item 7.1.3 is marked B in any column, item 7.1.2 must be marked A, and item 7.1.6 must be checked Z in the same column.

(o) If item 7.1.7 is marked other than Z in any column, item 7.1.8 must be marked on line A or B in the same column.

(p) If item 3.2.2(a) is marked with a code other than Z, item 7.3.1 must be marked A, B, or C.

(q) If item 7.3.1 is marked A or C, items 7.3.2, 7.3.3, 7.3.4, and 7.3.5 cannot be blank.

(r) If item 7.3.1 is marked A, item 7.4.0 must be marked Z.

(s) If item 7.3.1 is marked B or C, item 7.4.0 cannot be blank or marked Z.

(t) At least one of items, 8.3.1, 8.3.2, or 8.3.3 should have an entry against it if this part is being completed by corporate, group, or home office.

(3) To be complete the statement should include all significant cost accounting practices the contractor intends to use and must give enough information for the government to fully understand the accounting system being described. Accordingly, auditors should be alert for vague, incomplete or ambiguous answers which could lead to alternative accounting interpretations. Where such responses are noted, the auditor should discuss them with the contractor to ascertain the specific meaning. Unless the meaning is clarified, the auditor should recommend that the ACO find the statement inadequate if the item is material.

b. Materiality should be a major factor in deciding the level of detail required to be disclosed. A prime consideration should be whether a change in accounting procedure at the level of detail under consideration would have a material effect on the flow of costs, now or in the near future.

c. The following example demonstrates the attributes a description must have to

be considered current, accurate, and complete:

(1) Assume a contractor describes on a continuation sheet under item 4.6.0 that the cost of money is allocated to final cost objectives over the same base unit of measure as is used to allocate the other indirect expenses included in the cost pool to which the cost of money is related. Items 4.1.0(n), 4.2.0(n), and 4.3.0(1) are marked (Y) and the following explanation under the 4.5.0 is provided on the continuation sheet:

"The cost of money is computed in accordance with the procedures in CAS 414. We identify assets, calculate net book values, assign book value to indirect cost pools, and reallocate undistributed net book values to indirect cost pools by the same procedures as are used to identify and allocate depreciation to final cost objectives."

(2) The contractor's last historical indirect cost rate proposal and the current projected rates show that the cost of money rates were computed on the same allocation bases used to allocate expenses in the cost pools to which the cost of money is related. Therefore the description is current and accurate. The description, however, is incomplete. The contractor did not indicate whether the alternative method is intended to be used when the contracting parties can agree that the results of either method will be substantially the same. The contractor has also failed to indicate whether the cost of money is included in the G&A allocation base. To be complete the contractor should add the following narrative comments to the continuation sheets for items 4.5.0 and 4.6.0 respectively:

4.5.0 Continuation Sheet

"For any accounting period in which it can be demonstrated, and the ACO agrees, that no substantial difference will result, we will estimate, accumulate, and report by using the alternative method as described in CAS 414."

4.6.0 Continuation Sheet

"For all accounting periods, whether the regular or alternative method is used, we estimate, accumulate, and report by including the cost of money in the cost input base used to allocate G&A expense to final cost objectives."

d. The auditor need not review or report to the ACO the validity of the statistical data submitted annually by the contractor to update sales and regulated information.

8-207 Discussion with the Contractor

Before issuing the report to the ACO, discuss with the contractor all items considered inadequate (see 4-300).

8-208 Reporting

a. Since FAR 30.202-7(a) assigns the contract auditor responsibility for ascertaining the adequacy of the Disclosure Statement and its amendments, the required audits will be initiated and audit reports will be issued without the need for a request for audit services.

b. Prepare reports on initial adequacy audits in accordance with 10-800. If the report identifies inadequate descriptions and the ACO agrees the statement is inadequate, the ACO will formally notify the contractor, identify the inadequate items, and request that the statement be revised. The auditor will audit the revised statement to ensure that the contractor has taken corrective actions.

c. For each operating segment required to submit a Disclosure Statement, the cognizant auditor will be responsible for reporting the results of the adequacy audit of Parts 1 through 7. Even though data relating to Parts 1 through 7 may have been audited by other auditors who have cognizance over home office organizations, the report covering the operating segment will also include the results of the assist audits.

d. Except as described in e. below, all reports on the adequacy of Disclosure Statements will be submitted separately. When a Disclosure Statement is audited in connection with a pricing proposal, two reports will be required: one on the adequacy audit and the other on the evaluation of the pricing proposal. The report on the adequacy audit will not include recommendations concerning any actual or potential noncompliances. Noncompliance issues will be reported separately (see 10-806).

e. When a company submits proposed amendments to the Disclosure Statement which has previously been determined to be adequate, the auditor is required to follow reporting procedures that differ from those outlined in d. above. The auditor will audit the amendments for adequacy and compliance with CAS and FAR. The results of this audit will be included in a single report to the ACO if there are no noncompliance issues. If there are noncompliance issues, there will be two reports because noncompliances found in Disclosure Statement adequacy and compliance audits will be treated in the same manner as noncompliances found in other types of audits. That is, in addition to issuing the report on the adequacy of the Disclosure Statement, a separate noncompliance report will also be issued (see 10-806).

f. The auditor should always be aware of the importance of meeting the established due dates for adequacy reports. When unforeseen circumstances delay the issuance of the report, the ACO should be notified immediately and arrangements made for a new report due date. The ACO is responsible for determining the adequacy of the Disclosure Statement and a delay in submitting the audit report will delay the official notice to the contractor concerning the acceptability of the statement.

g. If subsequent audits indicate that a previously accepted disclosure statement is inadequate, the contractor should be

immediately advised in writing that a revision to the Disclosure Statement is necessary. For example, the contractor did not describe cost accounting practices related to a cost because it did not have a significant impact on the flow of costs to government contracts. Subsequently the cost becomes material and significantly effects the flow of costs. The contractor should revise its disclosure statement to adequately describe the practices related to the previously immaterial cost. If the contractor will not make the revision, the auditor should issue an audit report recommending that the ACO withdraw the adequacy determination and request the contractor to submit a revised disclosure statement (see 8-202c).

8-209 Maintenance of ACO Letters of Adequacy Determination

FAR 30.202-7(a) requires that the ACO generally notify the contractor, within 30 days after the receipt of the Disclosure Statement, whether or not the statement is adequate, and provide copies of letters of adequacy determination to the auditor and contracting officer. A copy of the most recent ACO letter of adequacy determination should be included in FAO files. Auditors should follow up with ACOs if an ACO letter of adequacy determination has not been received within 60 days after an adequacy report has been issued.

**8-300 Section 3 — Compliance with Cost Accounting Standards Board (CAS)
Rules, Regulations, and Standards and with FAR**

8-301 Introduction

a. This section provides audit guidance for the review of the contractor's Disclosure Statement and the practices used for estimating, accumulating and reporting costs on contracts subject to 41 U.S.C. 422. The purpose of the review is to ascertain whether the disclosed or established practices are in compliance with both the CASB rules, regulations, and standards and with appropriate acquisition regulations. The aspects of compliance reviews covered in this section are:

(1) General requirements including audit considerations and reporting procedures.

(2) Audit considerations involved in the initial review of the Disclosure Statement for compliance.

(3) Audit requirements associated with the review of cost accounting practices for compliance during the proposal evaluation and contract performance.

b. Not only should the auditor's review and subsequent reporting cover those conditions that constitute actual non-compliances but should also include circumstances where the occurrence of a planned or pending action will result in a violation of CASB rules, regulations, or standards. A condition of potential non-compliance exists when (1) a contractor with a covered contract proposes a practice that when implemented will violate a cost accounting standard, or FAR cost principle (see 8-302.7f), or (2) a contractor who does not have a covered contract but currently has or proposes to implement a practice which, with the award of the initial covered contract, will result in a violation of the CASB rules, regulations, and standards or appropriate acquisition regulations. It is important to note that in each of the potential non-compliance conditions described above, some future action is required before the contractor is in violation of 41 U.S.C. 422. For example, the offeror must be awarded a CAS-covered contract before it becomes subject to the rules and regulations of the CASB. Similarly, a covered

contractor must implement an unacceptable practice to be in actual noncompliance.

c. To facilitate the implementation process, each promulgated standard contains in subparagraph .80 an effective date and an applicability date. The CASB defers the applicability date beyond the effective date in order to provide contractors adequate time to prepare for compliance and make any required accounting changes. Under the regulation, a contractor becomes subject to a new standard only after receiving the first CAS-covered contract following the effective date. The distinction between the effective and applicability dates is important. The effective date designates when the pricing of future CAS-covered contracts must reflect the new standard. It also identifies those CAS-covered contracts eligible for an equitable adjustment, since only contracts in existence on the effective date can be equitably adjusted to reflect the prospective application of a new standard. The applicability date marks the beginning of the period when the contractor's accounting and reporting systems must comply with a new standard. Proposals for contracts to be awarded after the effective date of a standard should be reviewed carefully for compliance with the new standard. The proposal need only reflect compliance with the standard from the applicability date forward. Any changes resulting from early implementation may result in an equitable adjustment under FAR 52.230-2(a)(4)(iii) for the period prior to the applicability, if the parties agree to such early implementation. In unusual situations, the short lead time between the effective and applicability dates may create a difficult situation for the contractor. Where a contractor can demonstrate to the ACO that it would be virtually impossible to comply with the effective or applicability dates of a standard, contracts can be negotiated after the effective date of the standard based on the accounting system used before the standard. Contract terms should include provisions for price ad-

justments, retroactive to the applicability date, for significant cost impact resulting from the change in accounting practice to comply with the standard. In addition, the ACO should establish a specific date for the contractor to complete the changes to its estimating, accounting, and reporting systems and Disclosure Statement to comply with the standard. When this procedure is followed, noncompliances will not be reported. Equitable adjustments computed as of the applicability date will be submitted as provided in FAR 30.602-1. (See CAS Working Group Papers 76-7 and 77-10.)

d. Questions have been raised regarding the CAS compliance of termination claims since:

(1) costs in termination claims may be arranged differently than the cost presentations in the original estimates, and

(2) termination claims often include as direct costs such items as settlement costs or unexpired leases which would have been charged indirect if the contract had been completed. Termination costing procedures as detailed in FAR 31.205-42 are still effective. DoD does not view these procedures as violating either CAS 401 or 402, since terminating a contract creates a situation that is totally unlike completing a contract. Therefore, these costs would not be considered costs incurred for the same purpose in like circumstances. Termination contracting officers should assure themselves that within the context of termination situations, consistency is honored to the extent that the circumstances are similar. To that end, it would be advisable for a contractor to document its termination accounting procedures as part of its disclosed practices. Indirect cost rates used in termination claims must represent full accounting periods as required by CAS 406. (See CAS Working Group Paper 77-15.)

8-302 Noncompliance

8-302.1 Requirements

a. FAR 30.602-2 states that when the ACO determines a disclosed or an established practice is not in compliance the ACO shall notify the offeror or contrac-

tor, with a copy to the auditor. The notice shall require the recipient to advise the ACO and the auditor of the corrective action taken or to be taken to bring the practices into compliance. A revised Disclosure Statement may be required. In addition, adjustment of the prime contract price or cost allowance in accordance with FAR 30.602-2 may be required.

b. As in FAR 30.202-6 and 30.202-7, the contract auditor shall be responsible for conducting audits as necessary to advise the ACO as to whether the contractor's disclosed or established practices comply with CAS and FAR Part 31. Because the audit responsibility is a continuous requirement, instances of noncompliance may be detected and reported at various stages of the procurement action.

8-302.2 Types of Noncompliance

a. Eight types of noncompliance can be identified based on CASB rules, regulations, and standards and FAR Part 31:

(1) Disclosed practices not in compliance with CAS.

(2) Disclosed practices not in compliance with FAR.

(3) Actual practices of estimating costs not in compliance with CAS.

(4) Actual practices of estimating costs not in compliance with FAR.

(5) Actual practices of estimating costs not in compliance with Disclosure Statement.

(6) Actual practices of accumulating or reporting costs not in compliance with CAS.

(7) Actual practices of accumulating or reporting costs not in compliance with FAR.

(8) Actual practices of accumulating or reporting costs not in compliance with Disclosure Statement.

b. The first two noncompliance situations may be detected either during the initial Disclosure Statement review, during normal audits such as price proposal evaluations, or during reviews of incurred cost, as discussed in 8-304. Conditions three through five would likely be detected during a proposal evaluation or an estimating system survey. Situations six through eight would generally be

8-302.2b.

detected during normal or routine audits of actual costs.

c. In some cases multiple noncompliance conditions may exist. For example, a contractor normally allocates the costs of preparing initial bid proposals to cost objectives on the basis of total cost input. This practice, which conforms with FAR 31.205-18, and CAS 420, was previously disclosed to the government. For a new proposal, however, the associated B&P expenses were charged to the engineering overhead which was subsequently allocated to the resulting contract on the basis of direct engineering labor dollars. Under the conditions described above, noncompliance types (6), (7), and (8) would apply.

d. A new cost accounting standard could also result in instances of multiple noncompliance. For example, with the issuance of a new standard a disclosed practice previously considered to be in compliance could be rendered unacceptable in the following areas: (1) the described practice could be in noncompliance with CAS or FAR, and (2) the practices used to record costs, although in conformance with the Disclosure Statement, could be in noncompliance with CAS or FAR.

8-302.3 Compliance Considerations

In reviewing the contractor's cost accounting practices to ascertain whether they are in compliance with the cost accounting standards and FAR Part 31, the auditor should follow the guidelines below:

a. In evaluating price proposals and performing estimating system surveys, the auditor is required to describe inconsistencies between the contractor's estimating and cost accumulating practices. The auditor may, therefore, be in a position, based on past reviews, to ascertain whether the contractor complies with the standard requiring consistency in estimating, accumulating, and reporting costs.

b. The standard prohibiting double counting (CAS 402) did not introduce an entirely new groundrule since acquisition regulations contained similar provisions. The prohibition against double counting in the acquisition regulations, however,

was narrower in scope since it basically applied to individual contracts. CAS 402 has extended the scope by adding the requirement that each type of cost incurred for the same purpose, in like circumstances, must be either direct or indirect for all final cost objectives. Prior audits of the contractor's incurred costs may provide information on whether the cost accounting practices comply with this standard.

c. With respect to noncompliance with FAR Part 31, if a cost accounting practice has been questioned by the auditor in the past and the ACO has not made a final determination, the practice should be questioned again. Once the ACO makes a determination on the issue, the decisions will be followed. If the FAR is subsequently changed or a change in circumstance occurs, a practice should again be evaluated for compliance.

d. If a cost accounting practice has been questioned because of noncompliance with FAR Part 31 and the ACO supported the auditor's position, but the ASBCA or Court of Claims ruled against the government, the auditor will not question the practice again unless there is a subsequent change in FAR or the cost accounting standards which would negate the decision. However, if the ASBCA or the Court of Claims ruled in favor of the government, the practice should be questioned at all other contractor locations where circumstances are substantially the same.

8-302.4 Discussions with the ACO and the Contractor

a. The auditor should discuss noncompliance matters with the ACO at the earliest possible opportunity. It is important to keep the ACO informed of the auditor's actions and to identify areas where the auditor may need to provide further information regarding his or her recommendations.

b. As an integral part of the review, discuss the findings with the contractor. (See 4-300.)

8-302.5 Coordination for Consistent Treatment

a. Because of the consolidated contract audit function and the relationship of

CASB rules, regulations, and standards to the DCAA mission, DCAA is in an advantageous position to ascertain whether the promulgated standards, rules, and regulations are applied consistently. To fulfill this responsibility, DCAA must effectively coordinate all phases of audit reviews involving CAS.

b. Consistency in implementing CASB rules, regulations, and standards should be one of the auditor's primary concerns. Contractors are justifiably sensitive to unwarranted variations in the audit treatment of similar situations. To assure the provisions of 41 U.S.C. 422 are applied consistently, audit findings that are significant in amount or nature should ordinarily be coordinated with the region before the reports are issued.

c. When coordination involves other DCAA regional offices, the cognizant auditor should refer to his or her region those matters that cannot be resolved by the FAOs involved. The region may forward the matter to Headquarters, Attention PCD if agreement is not achievable at the regional level. (See 4-900.)

d. Information on other significant problems or controversial situations will also be provided to Headquarters, Attention PCD. (See 4-900.) This information will assist in developing guidance to improve auditing and reporting techniques or in referring matters to the Office of the Secretary of Defense (OSD) when DoD-wide guidance is needed to achieve uniform and consistent implementation of CAS.

8-302.6 CAS Coordination in CAC/CHOA/GAC Complexes

a. The DCAA CAC program, for major multisegment contractors and other specific groups of contractors, is described in 15-200. For multisegment contractors outside a CAC complex, a CHOA or GAC will be designated in accordance with 8-104.3. The CAC, CHOA, and GAC complexes play a significant part in promoting consistent treatment of CAS compliance issues among related or similar contractor segments.

b. Each CAC/CHOA/GAC will:

(1) Obtain from the cognizant FAOs the necessary data to compile a listing of all known noncompliance issues at each

of the segments that comprise the complex. The listing, along with information on resolution of the issues, should be distributed to all FAOs that have cognizance of any segment within the complex.

(2) Review and update the listing for new instances of noncompliance and include information regarding noncompliance issues resolved. Circulate this data to the cognizant FAOs to keep them informed about current developments.

(3) Before issuing a noncompliance report, review and discuss the recommendations with the FAO. This should be done to assure consistent treatment of similar conditions at the various segments of the complex.

(4) Recommend workshops if needed to review mutual CAS problems, in accordance with 15-200.

c. FAOs in the complex will:

(1) Inform the CAC/CHOA/GAC of known problem areas.

(2) Inform the CAC/CHOA/GAC immediately when new problem areas are encountered.

(3) Review problem areas of other organizational units to determine if similar problems exist or could exist at your location.

(4) Plan audits so findings can be coordinated before reports are issued.

8-302.7 Reporting Noncompliance

a. In assigning responsibilities to the ACO and the contract auditor (FAR 42.302(a)(11), DFARS 242.302(a)(11), FAR 30.601, and FAR 30.202-6), the regulations require the auditor to conduct audits of Disclosure Statements for adequacy and compliance, and report practices that do not comply with CASB rules, regulations, and standards. The ACO is to determine whether the reported practices actually do not comply with the CASB promulgations or FAR Part 31. Noncompliance reports should include only CAS violations that the auditor considers significant. The auditor should report:

(1) Violations of major requirements of CAS regardless of their effect on contract costs.

(2) Noncompliances having a significant cost effect on CAS-covered contracts.

(3) Noncompliances that currently have no significant effect on contract costs but could eventually result in a significant adjustment because of changed circumstances.

(4) Noncompliances that are an inherent part of the contractors' cost accounting system and that are of such a nature that the cost effect on CAS-covered contracts would be difficult or impossible to determine. (In ASBCA Case No. 20998, the Board upheld the government's right to determine a contractor to be in non-compliance, even though the government was unable to determine that increased costs resulted from the noncompliance. This ASBCA decision should be referenced in all audit reports recommending noncompliance where the cost impact cannot be determined.)

b. The following are examples of practices that deviate from CAS. Even if such practices have not resulted in increased cost, or no increased cost can be determined, the conditions described are reportable as noncompliances.

(1) A contractor allocates home office expenses to divisions as fixed management charges. The charges are less than the amounts which would have been allocated had the contractor followed CAS 403. The auditor should recommend that the ACO advise the contractor that costs will be disapproved when the method used by the contractor results in an amount exceeding that which would have been allocated under the standard.

(2) Another contractor estimates labor cost by category, i.e., fabrication assembly, inspection, etc. The actual costs are accumulated in one undifferentiated account. Under these circumstances, the auditor would not be able to determine if there is any cost effect since there are no records to compare. The auditor should report the noncompliance and recommend that the contractor be required to follow consistent practices in estimating and accumulating labor costs.

c. The following guidance should be followed in reporting instances of non-compliance with CAS.

(1) The auditor may discover instances of noncompliance while performing any of his or her other audit functions, i.e., price evaluations, audit of incurred costs,

Disclosure Statement adequacy and CAS compliance audits, and functional audits. Regardless of the circumstances under which noncompliance items are found, the auditor will include noncompliance issues in a separate report (activity code 19200). To avoid unnecessary and duplicative reporting, the CAS noncompliance will be fully described in the noncompliance report and other reports may merely cross-reference that report.

(2) Generally, when there are noncompliances with more than one CAS, separate noncompliance audit reports should be issued for each noncompliance. However, in certain circumstances, noncompliances with two or more standards can and should be issued in the same report. This would occur when the noncompliances are related or inseparable. Noncompliances are related or inseparable if the resolution of one resolves the other. Usually, there should not be multiple reports issued for noncompliances with a single CAS.

(3) Reports will be issued as the auditor discovers instances of noncompliance during normal audit functions. A report is not required when the contractor's Disclosure Statement is found to comply with the CAS and FAR Part 31. Neither is there a requirement for contract audit closing statements and audit reports on final pricing to include a "clearance" statement with respect to compliance with 41 U.S.C. 422.

d. The auditor is responsible for conducting audits as necessary to ascertain that contractors are complying with CAS. Therefore, a general request by an ACO for reports and/or comments on contractor compliance is not needed. If such a request is received, inform the ACO that although DCAA does perform compliance audits of specific Cost Accounting Standards, we do not issue reports on contractor overall compliance. (However, see 8-304.2 and 8-304.3 regarding scheduled annual audit compliance reviews.) Offer to audit and report on any specific area that the ACO may suspect is noncompliant. If a CAS compliance audit is already planned in the area of concern specified by the ACO, the audit should be rescheduled to coincide with the ACO request. When an audit

relating to a particular identified practice is requested, the auditor and the ACO will establish a mutually acceptable date for submitting the audit results. The auditor will then include the required audit steps to cover the questioned practice in the next scheduled audit or, if necessary, will schedule a special audit. The ACO's request to review a specific practice should be given prompt consideration but should not receive higher priority than proposal evaluations. After the audit, issue either a report on noncompliance or a brief report to inform the ACO that the audit disclosed no noncompliance in the specific area cited by the ACO.

e. Reports on noncompliance will be prepared and distributed per 10-806.

f. FAR 30.202-7(b) establishes a policy that noncompliance with FAR shall be processed separately. Noncompliance with CAS comes under FAR 52.230-2(a)(5), whereas noncompliance with FAR must be treated as a government-proposed accounting practice revision under FAR 52.230-2(a)(4)(iii) (see 8-502.7). Consequently, the separate audit reports citing noncompliance with FAR should recommend that the ACO process the accounting practice revision as a government-proposed accounting practice revision pursuant to FAR 52.230-2(a)(4)(iii).

g. Outstanding noncompliance issues (issues included in a previous noncompliance report) may affect reviews and reports related to other audit functions. Price proposal evaluation and other audit reports should not reference any situation as noncompliant unless a separate noncompliance report has been issued, except as noted in 8-414.1g. If a noncompliance report has been issued, the evaluation of a price proposal must comment on and should question the impact of the noncompliance item on the proposal being reviewed.

8-303 Review of Disclosure Statement and/or Established Practices to Ascertain Compliance with CAS and FAR

8-303.1 Requirements

a. FAR 52.230-2 requires the contractor to adequately disclose its cost ac-

counting practices for all covered contracts. An initial review of the Disclosure Statement will be made to ascertain compliance with Public Law 91-379. This review may be made concurrently with the adequacy review. However, the report on the Disclosure Statement adequacy should not be deferred until the review for compliance is completed.

b. A noncompliance disclosed during an evaluation of a price proposal should be included in a separate report and submitted to the ACO with the evaluation report.

c. Audit files may contain sufficient information to determine whether the Disclosure Statement complies with 41 U.S.C. 422, related regulatory provisions, and FAR. The auditor should identify all significant areas where the contractor's disclosed practices are not in compliance. Audit working papers should sufficiently document the auditor's opinion regarding whether the contractors' disclosed practices comply with CAS and FAR.

d. FAR 30.202-7(b) provides that the contractors' cost accounting practices should comply with FAR Part 31 as well as CAS. However, the auditor should report as noncompliances only those FAR violations that involve the direct and indirect allocation or classification of costs. Essentially, this limitation excludes reporting as noncompliance those FAR violations based solely on reasonableness or allowability.

8-303.2 Initial Reviews of Compliance

Initial compliance reviews, as a rule, should be scheduled for completion within 60 days after the ACO has made a determination of adequacy. To avoid unnecessary effort at contractors having limited government business, the auditor should find out whether a covered contract has been awarded before engaging in extensive audit effort to ascertain compliance.

8-303.3 Changes to Disclosure Statements and/or Established Practices

a. In accordance with FAR 52.230-5, the contractor must submit proposed accounting changes to the ACO together with an estimate of the general dollar magnitude of the cost impact. The time

frames for submission of the proposed changes are referenced in FAR 52.230-5(a). FAR 30.302 provides definitions of "cost accounting practice", "change to a cost accounting practice" and contains illustrations of changes. CAS Working Group Guidance 81-25 concluded that a change from a percentage of completion to a completed contract method of computing state taxes was an accounting change. A change from a completed contract to a percentage of completion or a percentage of completion - capitalized cost method as required by the Tax Reform Act of 1986 is also to be considered an accounting change.

b. An important CAS audit responsibility is to ascertain whether accounting changes made by a contractor require a revision to the Disclosure Statement. Therefore, auditors should request the contractors to establish procedures to promptly notify the government of all proposed accounting changes. When a Disclosure Statement revision is required but is not made, a noncompliance report should be issued (e.g., practices used to record costs are not in compliance with Disclosure Statement). When a revision to the Disclosure Statement is submitted, the ACO will obtain the contractor's proposal reflecting the cost impact of the change (FAR 30.602-3(b)). The auditor will make an evaluation to ascertain the acceptability of the contractor's proposal. A condition of noncompliance could result from the contractor's failure to follow the administrative procedures prescribed by FAR 52.230-5 in making an accounting change.

c. A condition of noncompliance exists if, for example, a contractor estimates a contract using a cost accounting practice consistent with its Disclosure Statement and, at some point during the performance, changes the methods for computing and accumulating a labor class, whether or not it was listed as a principal class of labor in the Disclosure Statement. Costs are being accumulated in a manner inconsistent with estimating practices and not in accordance with the Disclosure Statement. The report to the ACO should recommend that (1) determination of noncompliance (CAS 401) be made, (2) a cost impact proposal be

requested from the contractor to evaluate the effect of the changed practice, and (3) a revised Disclosure Statement be requested from the contractor describing all principal classes of labor.

d. Preamble J of Part 331 of the CASB's rules, regulations, and standards (see Appendix to FAR, Part 30) contains a discussion by the CASB on organizational changes. The preamble states in part that "... business changes by themselves are not changes in cost accounting practices." However, it also states that "The decision as to whether there is a change in cost accounting practice is made through an analysis of the circumstances of each individual situation being promulgated in these regulations." Organizational changes which result in a change in the measurement of costs, the assignment of costs to cost accounting periods, or the allocation of costs to cost objectives should be considered to be changes in cost accounting practice requiring an adjustment to CAS covered contracts for any increased costs. Changes in the composition of the pools and bases as a result of consolidation or separation of business units' indirect pools or bases due to organizational changes will be considered to be a change in cost accounting practice; i.e., a change in the allocation of costs to cost objectives.

e. When a Disclosure Statement change is submitted, the auditor should ascertain its adequacy and compliance before the effective date. The time frame for completing these reviews should be coordinated with the cognizant ACO. The auditor will issue a single report including his or her opinions on both adequacy and compliance. (See 8-208e.)

8-304 Review of Estimated, Accumulated, and Reported Costs to Ascertain Compliance with CAS and FAR

8-304.1 Requirements

Under the provisions of FAR 30.202-6(c), the cognizant contract auditor is responsible for determining whether a contractor's cost accounting practices comply with CAS and FAR. This review

for compliance is required for all contractors that have contracts containing the CAS clause without regard to whether a Disclosure Statement has been submitted.

8-304.2 Compliance Considerations

a. The annual audit plan shall be used to ensure that compliance reviews are scheduled during the performance period of covered contracts to determine if the contractor's actual practices comply with its disclosed accounting practices, applicable cost accounting standards, and FAR Part 31 (see 8-305). FAO management information system summaries will provide a list of the audits performed which support the opinions on CAS compliances included in audit reports. The summaries are to be used as an audit management tool for assuring that adequate CAS compliance testing is being performed.

(1) The initial Disclosure Statement adequacy and compliance review for a new standard should be scheduled as soon as possible after the effective date of the new standard. The timeliness of the review is especially important for those practices which may involve significant costs. If the review is performed soon after a new standard's effective date, the auditor will have a basis for determining whether the accounting practices reflected in pricing proposals comply with the new standard.

(2) During the first contractor fiscal year that a new standard is applicable, planned audits, such as forward pricing and estimating system reviews, should review for compliance of actual practices. If a compliance review cannot be accomplished concurrently with the planned audits, then a separate compliance review should be scheduled and performed to determine if actual practices comply with the new standard.

b. The inclusion of the CAS clause obligates the government to determine compliance even though the contractor may not have been required to file a Disclosure Statement. The objective and scope of audit reviews made during contract performance to determine compliance with applicable cost accounting standards should be the same regardless

of whether the contractor has submitted a disclosure statement. This approach would also apply to the review of contractors' cost accounting practices to determine consistency with FAR Part 31 and related supplements.

c. The decision to report a condition as noncompliant should be based on whether the violation is intrinsically related to the contractor's methods used to assign costs to cost objectives. The CASB rules, regulations, and standards are essentially concerned with practices used by contractors to estimate, accumulate, and report costs on government contracts. Reasonableness and allowability are criteria administratively established by acquisition regulations and contractual terms and do not necessarily involve cost accounting practices. Audit recommendations that are based on considerations of cost allocability (that is, the assignment of cost to the cost objective that caused or received the benefit from the expenditure) should be included in noncompliance reports. Audit recommendations based on reasonableness and allowability should not be included in noncompliance reports.

8-304.3 Reporting of Compliance Audit Results

a. An audit report should be issued whether the audit disclosed instances of noncompliance or not. The audit report should inform the ACO of the specific area being audited even if the audit disclosed no instances of noncompliance. If noncompliance is disclosed, the audit report should explain in detail the issues involved.

b. The auditor may detect noncompliance at any stage of a procurement action. Noncompliance should be reported whenever detected. Special care is necessary to ensure that proposal evaluation reports that reveal instances of noncompliance are accompanied by a noncompliance report.

8-305 CAS Compliance Testing

8-305.1 General Requirements for Compliance Testing

CAS deals fundamentally and exclusively with the identification, measure-

ment, and allocation of costs. Because these considerations are inherent to contract auditing, reviews for CAS compliance must be fully integrated into all areas of audit activity. Materiality and audit risk assessment, and historical CAS problems experienced are an integral part of the planning process and should be considered in developing the extent and frequency of CAS compliance tests.

8-305.2 Compliance Review Testing

The following criteria should be used in establishing CAS compliance testing requirements:

a. Identify those provisions of a standard which are significant to the particular contractor. The materiality criteria published in 48 CFR 9903.305 must be considered carefully. Since the CASB stated that a purpose of CAS is to facilitate the audit and administration of government contracts, the significance of accounting and administrative requirements to those functions should also be considered. If noncompliance with a CAS provision would have no significant impact on either government contract costs or the administrative and audit effort, there is no need to test whether the

contractor is complying with the provisions. If a provision is considered immaterial, then document this on the requirements plan working papers. The materiality decision should be reconsidered whenever relevant circumstances change. This step will be done for each CAS-covered contractor. The documentation need not be extensive when audit activity and costs are not significant. An entire standard may be determined immaterial on the basis of overall consideration of related costs.

b. During annual audit planning (see Chapter 3 and Appendixes G and H), identify those audits for which tests of CAS compliance are necessary. Plan testing for compliance with CAS 401 and 402 during the performance of audit assignments such as proposal evaluations and incurred cost audits. Establish separate assignments for compliance audits for all other standards. As a minimum, CAS compliance audits on all applicable and significant standards should be done every three years. If the three-year cycle is not maintained, explanations should be included in the requirements plan working papers.

8-400 Section 4 — Cost Accounting Standards**8-400 Introduction**

This section contains guidance on implementing specific cost accounting standards (CAS). Additional illustrations are included in an attempt to provide auditors with a common understanding of the standards. This section will be amended to include specific audit guidance for the standards promulgated in the future.

8-401 Cost Accounting Standard 401 — Consistency in Estimating, Accumulating and Reporting Costs

a. The purposes of this standard are (1) to achieve consistency in the cost accounting practices used by a contractor in estimating costs for its proposals with those practices used in accumulating and reporting costs during contract performance, and (2) to provide a basis for comparing such costs. The standard was effective and applicable to all CAS-covered contracts awarded after 1 July 1972.

b. Cost accounting practices should be applied consistently so that comparable transactions are treated alike. The consistent application of cost accounting practices will facilitate the preparation of reliable cost estimates used in pricing a proposal and the comparison of those cost estimates with the actual costs of contract performance. Such comparisons of estimated and incurred costs provide (1) an important basis for financial control over costs during contract performance, (2) means for establishing accountability for costs in the manner agreed to by both parties at the time of contracting, and (3) an improved basis for evaluating estimating capabilities.

8-401.1 Consistency between Estimating and Accumulating Costs

a. The consistency requirement between estimating and accumulating costs is a two-part requirement. First, the contractor's practices used to estimate costs in pricing proposals must be consistent with practices used in accumulating actual costs. Second, the contractor's practices used in accumulating costs must be

consistent with practices used to estimate costs in pricing the related proposal. Thus, noncompliance with the standard can exist because a contractor has failed to estimate its cost in accordance with its established or disclosed accounting practices; noncompliance can also occur when a contractor estimates in accordance with its disclosed or established practices but accumulates on a different basis without obtaining the prior agreement of the government.

b. One of the primary problems involved in the implementation of this standard relates to the consistency in the level of detail provided in estimating contract costs and accumulating contract costs. Greater detail in the accumulating and reporting of contract costs than in the pricing of proposals is permitted by CAS 401.40(c) which states that, "The grouping of homogeneous costs in estimates prepared for proposal purposes shall not per se be deemed an inconsistent application of cost accounting practices. . . ." Although the grouping of homogeneous costs for estimating purposes is permitted, the auditor should be aware that CAS 401.50(a) requires that ". . . costs estimated for proposal purposes shall be presented in such a manner and in such detail that any significant cost can be compared with the actual cost accumulated and reported therefor." In other words, the grouping of costs for proposal purposes does not result in noncompliance as long as the costs are homogeneous and if comparisons between actual costs and proposed costs are possible. The following are examples of permissible grouping of costs as presented in CAS 401.60(a)1 and 3.

"... 1. Contractor estimates an average direct labor rate for manufacturing direct labor by labor category or function. Contractor records manufacturing direct labor based on actual cost for each individual and collects such costs by labor category or function."

"... 3. Contractor uses an estimated rate for manufacturing overhead to be applied to an estimated direct labor base. It identifies the items included in its

estimate of manufacturing overhead and provides supporting data for the estimated direct labor base. The contractor accounts for manufacturing overhead by individual items of cost which are accumulated in a cost pool allocated to final cost objectives on a direct labor base."

c. Noncompliance can occur when there is greater detail in the estimating of contract costs than in the accumulating and reporting of costs as indicated by the following example in CAS 401.60(b):

"... 5. Contractor estimates engineering labor by cost function, i.e., drafting, production engineering, etc. Contractor accumulates total engineering labor in one undifferentiated account."

(1) In the above circumstances, should the potential noncompliance with CAS 401 be rectified by providing less detail in estimating or more detail in accumulating costs? If the contractor revises its price proposal and shows the estimate for engineering labor as one amount, it achieves consistency with its method of accumulating these costs and technically corrects the noncompliance. However, an agreement to eliminate all details in the estimate would deprive the government of information needed to effectively evaluate the pricing proposal. This extreme approach should be rejected and cited as an estimating system deficiency.

(2) FAR 15.804, DFARS 215.804, and Armed Services Pricing Manual (ASPM No. 1) contain guidance as to the level of detail required for cost or pricing data submitted in connection with negotiated noncompetitive contracts. FAR Table 15-2 (notes to Standard Form (SF) 1411, Contract Pricing Proposal Cover Sheet) constitutes an appropriate baseline for establishing the detail to be furnished. If the contractor's estimates are in accordance with this baseline, and are in greater detail than costs in the records, the auditor should normally recommend that costs be accumulated in a manner consistent with the estimate. A reduction in the estimating details would be acceptable only if the contractor's submission satisfies the FAR/DFARS provisions cited above and the requirements of acquisition officials.

(3) In determining the appropriate level of detail for consistent use in estimat-

ing and accumulating costs, the auditor should bear in mind that in many instances procuring contracting officers (PCOs) may request contractors to furnish estimates in a special manner. Such a request may require more information than needed for cost accumulation purposes or cause information to be arranged in a way that is not consistent with the manner in which the contractor intends to accumulate the actual costs.

(4) If the auditor finds estimates of significant items of costs in a pricing proposal which will not be comparable with the actual cost accumulated, he or she should discuss the inconsistency with the contractor. The auditor should point out the areas of potential noncompliance and advise the contractor of the audit recommendations she or he proposes to make to the ACO. If the contractor contends that it presented the information in the price proposal for negotiation purposes only and did not intend to accumulate costs in such a manner, the auditor should inform the contractor that she or he will recommend the contracting officer request a cost estimate that summarizes the cost data in a manner compatible with the cost accumulation plan. The auditor should review the cost summaries to determine if sufficient data are presented to meet the requirement of the Request for Proposal. The auditor's opinion on whether the summaries contain an acceptable level of detail for accumulation purposes should be included in the report to the ACO.

d. The promulgation of CAS 401 raised a question among auditors as to whether applying a percentage factor to proposed material costs to cover expected losses would comply with the standard if the contractor maintained no separate historical loss records. The CASB issued Interpretation No. 1 to CAS 401 in 1976 to deal with that particular issue. The interpretation provides that contractors who estimate material losses by applying a percentage factor to a base, such as total material requirements, must support the factor with historical experience. The interpretation does not prescribe the type or level of detail necessary to comply with the standard. Government contracting authorities should decide the amount

of statistical or accounting data required based on the individual circumstances. It should be emphasized that the contractor should be cited for noncompliance whenever factors are applied to totals or subtotals of material requirements, and during contract performance the contractor does not maintain a separate record of the costs represented by the proposed factor. Adding a uniform percentage to each line item in the bill of material is the same as adding a single percentage to the total basic material cost. In the two examples above, the contractor would have to maintain a separate accounting record for the additional material purchased during contract performance to be in compliance with the CAS 401. However, when the contractor adjusts the quantities of individual line items in the bill of material, either by applying a factor or by adding a specific quantity of additional units, the contractor is deemed to have complied with the standard. This is because the estimate is a representation of the total cost of individual parts. In most situations, the cost and quantity of individual parts used can be determined from the accounting records. Nothing in the Interpretation No. 1 to CAS 401 should be construed to alter or modify the requirements that the contractor submit adequate cost or pricing data. Refer to 9-200 for evaluating the adequacy of cost or pricing data in proposals.

8-401.2 Consistency in Reporting Costs

a. As used in the standard, "Reporting of Costs" refers to (1) data presented in reports required by the contract such as budget and management reports for cost control purposes and (2) the data contained on public vouchers or any other request for payment.

b. The primary interest is to ascertain whether the accounting practices used to determine the costs presented in these reports are consistent with the accounting practices used to estimate and accumulate the costs. It would not be expected that a public voucher will contain the same level of detail as a pricing proposal or that the details in a budget or management report will be limited to that in the proposal. The auditor will ascertain

whether the accounting practices for selecting indirect cost pools and methods of distributing the indirect costs used to determine the amounts on those reports are consistent with those used for estimating and accumulating. In addition, the standard does not prohibit the use of reporting systems with unique requirements such as the applied cost concept used for C/SCSC purposes and certain estimating techniques used to project contract estimates at completion under C/SCSC contracts. Further, the standard does not prevent the use of forecasted indirect cost rates for billing as long as the pools and allocation bases used to develop those rates are consistent with those used for estimating and accumulating costs.

c. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendation as outlined in 8-302.7.

8-401.3 Illustrations

The following illustrations are intended to supplement those in paragraph 401.60 of the standard. They are to be used as a guide in determining the contractor's compliance with the standard.

a. **Problem.** A contractor's proposal shows the cost of engineering labor by class, i.e., Engineer I, Engineer II, etc. However, it is the contractor's practice to accumulate engineering labor by type, i.e., Electrical Engineer, Design Engineer, etc. Such practices would violate CAS 401.

Solution. If the contractor submits a summary of the proposal by type of engineer which (1) reconciles with the proposed cost by class of engineer, (2) meets the requirement of the SF 1411 and FAR Table 15-2, and (3) further explains that this is the manner in which cost will be accumulated, then consistency with CAS 401 will have been achieved. The auditor should be careful to determine whether the PCO intended to buy a specific number of hours by class of engineers. In such a case, the contracting officer should require the contractor to estimate and accumulate by the same classes of engineers. By this requirement, consistency with the cost accumulation records will be achieved without dimin-

8-401.3a.

ishing the level of detail in the estimate. In this regard, it should be remembered that any special breakdown required by the contracting officer is a matter for discussion between the contracting parties and is not dealt with by CAS 401.

b. Problem. A contractor estimates cost by line item, i.e., data, first article test, and hardware, and then submits a single SF 1411 for all three items. The contractor does not intend to accumulate the cost of each item separately but rather, in accordance with its established accounting practice, accumulate labor, material, and indirect costs for the contract as a whole. In this instance, the contractor's accumulation records are in lesser detail than its estimating constituting a non-compliance with CAS 401.

Solution. (1) An acceptable approach to correcting the apparent inconsistency between the estimating and accumulating practices is to require the contractor to develop an estimate in accordance with the requirements of the SF 1411 and FAR Table 15-2. Where the contractor elects to estimate and accumulate the combined costs of the three line items by cost elements (direct labor, material, indirect costs, etc.), such a practice does not necessarily constitute a violation of CAS 401. This is true because the level of detail required by the SF 1411 and FAR Table 15-2 has been authoritatively established as an acceptable baseline for compliance with the standard. However, when the contractor chooses this alternative, the contracting officer should be promptly advised in the event that a level of detail of costs incurred that go beyond the essential requirements of CAS 401 is needed for proper contract administration.

(2) On the other hand, if the contractor is required to submit a separate SF 1411 for individual contract line items and the cost of each item is material in amount and inherently distinct from other items for which costs are separately accumulated, the contractor probably should be required to accumulate cost by line items. In effect, where required by the contracting officer, the cost of each line item should be estimated and accumulated as if each were a separate contract. Examples of contracts whose costs should be

estimated and accumulated in such a way are those which provide for (1) design, prototype development, and production or (2) distinct and disparate end items of production.

c. Problem. A contractor prepares separate estimates for the cost of raw material, subcontracts, purchased parts, and interdivisional transfers. The costs of these items are not separately identified in the accounting records.

Solution. The practice is in noncompliance with the standard and the contractor should be required to accumulate costs consistent with its estimates. However, the standard permits supplemental records if they are reconcilable to the formal accounting records.

d. Problem. During the review of a price proposal, an auditor finds that a contractor uses a material additive factor to cover the cost of small common-usage items. In preparing the price proposal, the cost of this factor is estimated as an historical percentage of direct material requirements. In accumulating costs, these items are computed as a percentage of direct productive labor hours.

Solution. The condition described above contravenes the provisions of CAS 401. The auditor should recommend a determination of noncompliance and that the contractor change its actual practices to conform with the practices disclosed or established. For example, if the contractor's disclosed or established practice is to accumulate the cost of small common-usage items as a percentage of direct productive labor hours, then the estimating practice should be changed to be compatible with the method of accumulating such costs. In the price evaluation report, the excess cost estimated as a direct result of using a practice that is inconsistent with the contractor's disclosed or established practices will be quantified and questioned. The validity of alternative methods of estimating and costing will be determined in accordance with guidelines included in 6-300 and 9-400.

8-402 Cost Accounting Standard 402 — Consistency in Allocating Costs Incurred for the Same Purpose

a. The purpose of this standard is to ensure that each type of cost is allocated

only once and on only one basis to any contract or other cost objective. The fundamental requirement is that all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. The standard was effective and applicable to all CAS-covered contracts awarded after 1 July 1972.

b. The key words in applying this standard are "costs incurred for the same purpose in like circumstances." The illustrations in CAS 402.60 show the need for a thorough examination of the facts before concluding whether or not an accounting practice is resulting in noncompliance with the standard. For example, CAS 402.60(b)(2) demonstrates how a cost, although incurred for the same general purpose, (i.e., fire fighting) should be viewed in terms of its more specific purposes (i.e., protection of the entire plant versus protection of a special area) which permits the costs to be allocated to final costs objectives in a different manner. It is essential to examine all of the facts and to avoid making determinations on the basis of general information or nomenclature.

c. CAS 400.1(a) defines a proposal as: "any offer or other submission used as a basis for pricing a contract, contract modification or determination settlement or for securing payments thereunder." Interpretation No. 1 to CAS 402 was promulgated in 1976 to clarify the circumstances under which a contractor could charge proposal costs both direct and indirect without violating the standard. The interpretation concludes that not all proposal costs are incurred in like circumstances. Proposal costs incurred pursuant to the specific requirement of an existing contract, such as proposal cost incurred in connection with the definitization of letter contracts and with orders issued under basic ordering agreements, are considered to have been incurred in a different circumstance than other proposal costs and may be charged direct to the specific contract. Costs of preparing proposals will be treated as indirect costs except where such effort is specifically required by contract provision.

d. If noncompliances are found, the auditor must ascertain their significance

and make the appropriate recommendations as outlined in 8-302.7.

8-402.1 Illustrations

The following illustrations are intended to supplement those in section 402.60. They are to be used as a guide in determining whether the contractor complies with the standard.

a. **Problem.** A contractor has a government contract which requires extra effort for planning and cost management. It hired extra people to accomplish this effort and accounted for all their labor cost as a direct charge to the contract. The contractor has other people performing the same functions for more than one contract and their labor is charged to indirect costs.

Solution. Since the work being performed is the same and the only difference is in the amount of effort required to accomplish the function, this practice would not comply with the standard. The contractor could correct the situation by (1) charging all of these costs to indirect costs and developing an equitable distribution base or (2) direct charging all of these costs.

b. **Problem.** A contractor charges engineering consultant costs incurred on IR&D projects to engineering overhead; the same costs incurred for research and development contracts are charged direct to the contracts.

Solution. This practice does not comply with the standard because the same type of costs incurred in similar circumstances are charged to cost objectives on different bases. Also, the practice does not comply with FAR 31.205-18, and CAS 420 which requires that direct and indirect costs for IR&D projects be determined on the same basis as if the IR&D projects were under contract. Since the benefiting projects can be specifically identified, the consultant costs should be charged directly to those projects.

c. **Problem.** A contractor has hundreds of cranes located throughout a shipyard. Their maintenance, taxes, and depreciation costs are recorded in a general account and then allocated to departmental overhead pools for distribution to contracts. The Dry Dock has the cost of eight cranes charged directly to its de-

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partmental overhead pool because their use is unique to the Dry Dock operations.

Solution. Since the Dry Dock cranes are used for a special purpose and the Yard cranes for general purposes, this practice would not result in double counting. However, if any of the Yard cranes are also used for a special purpose, such as new ship construction, the practice would result in double counting and noncompliance with the standard. Under those conditions all of the special purpose cranes should be eliminated from the general account and charged directly to the using department to correct the problem.

**8-403 Cost Accounting Standard 403
— Allocation of Home Office
Expenses to Segments**

a. The purpose of this standard is to establish criteria for allocation of home office expenses to the segments of the organization on the basis of a beneficial or causal relationship. The appropriate implementation of this standard will limit the amount of home office expenses classified as residual to the expenses of managing the organization as a whole.

b. The standard was effective 1 July 1973 and, after receipt of a CAS-covered contract, is to be followed by each contractor as of the beginning of its next fiscal year. The standard exempts contractors who are subject to the provisions of Office of Management and Budget Circular Nos. A-21 and A-87 (Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Educational Institutions and Principles for Determining Costs Applicable to Training and Other Educational Services under Grants and Contracts with State and Local Governments)."

8-403.1 General

a. With the adoption of this standard, contractor and government personnel have a specific, authoritative accounting rule prescribing criteria for allocating home office and group office expenses to segments of an organization. For purposes of the standard, the term "home

office" is defined in CAS 403.30(a)(2) as an "office responsible for directing or managing two or more but not necessarily all segments of an organization." The definition expressly includes intermediate levels, such as group organizations which report to a common home office. An intermediate level may be both a segment and a home office.

b. The basic concept of the standard recognizes that some home office expenses incurred for specific segments can be assigned directly. Other expenses, not incurred for specific segments, have a clear relationship (i.e., measurable with reasonable objectivity) to two or more segments. Lastly, the standard recognizes a third type of home office expense (i.e., residual) which possesses no readily measurable relationship to segments. Consistent with this concept of home office expenses the standard requires that:

(1) Those expenses incurred for specific segments are to be allocated directly to those segments to the maximum extent practical.

(2) Those expenses not directly allocable, but possessing an objective measurable relationship to segments, should be grouped in logical and homogeneous expense pools and distributed on allocation bases reflecting the relationship of the expenses to the segments concerned.

(3) When the residual expenses are considered material because they exceed a specified percentage of total company operating revenue (as defined in CAS 403.40(c)(2)), a three-factor formula must be used to allocate these expenses. The three-factor formula consists of payroll dollars, operating revenue (net of interdivisional purchases), and average net book values of tangible capital assets and inventories (net of progress payment billings). If the residual expenses do not exceed this threshold, they may be allocated to all segments by means of any allocation base representing the total activity of such segments. Regardless of the method, there may be instances where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation of such expenses pursuant to the standard. In these cases, a special allocation may be agreed to by the parties

provided such special allocation is commensurate with the benefits received (CAS 403.40(c)(3)).

c. A requirement of the standard is that home office expenses shall be allocated on the basis of the beneficial or causal relationship between supporting and receiving segments. In establishing this requirement, the CASB stated that materiality is an important consideration in determining whether an expense should be allocated directly or accumulated in a homogeneous expense pool and allocated on a basis reflecting the causal or beneficial relationship of the pooled expenses to the receiving segments. In addition, CAS 403.40(b) provides criteria for allocating six groupings of home office expenses. Residual expenses are defined in CAS 403.40(c) as all home office expenses which are not otherwise allocable pursuant to the standard.

d. The standard provides for an annual test to ascertain whether the residual expenses must be allocated on the basis of the prescribed three-factor formula or if the contractor may use any appropriate base. For the first year the contractor is subject to this standard the determination "shall be based on the pro forma application of this standard to the home office expenses and aggregate operating revenue for the contractor's previous fiscal year" (CAS 403.40(c)(2)). The contractor is responsible for determining whether or not the company should propose the use of any base representative of the total activity of the segments or if the three-factor formula must be used. The pro forma submission must comply with the standard.

8-403.2 Guidance

a. Contractors becoming subject to this standard must:

(1) Revise their home office expense pool structure and methods of distributing the expenses where necessary to comply with CAS 403.40.

(2) Amend Disclosure Statements to describe the new pool structures and methods of distribution.

(3) Estimate the cost of the first and all subsequent contracts subject to this standard using the new pool structures and methods of distribution. Failure to do so

would result in noncompliance with CAS 401 when costs are subsequently recorded in accordance with CAS 403.

(4) Submit a proposal for the equitable adjustment of all CAS-covered contracts which were negotiated before the effective date of the standard and are affected by the change in cost accounting practices.

b. Amendments to a Disclosure Statement are subject to the same audit review and reporting requirements as the original Disclosure Statement. Auditors should be especially careful in evaluating the adequacy of responses to Item 8.5.0 of the Disclosure Statement concerning the composition of the allocation base. The description should provide enough information to determine that the contractor is treating all of the elements in the base in the same manner at all divisions.

c. To ascertain that the accounting practices comply with the standard the auditor should determine that (1) expenses have been properly classified as directly allocable, indirectly allocable, or residual, (2) the "logical and relatively homogeneous pools" are "allocated on bases reflecting the relationship of the expenses to the segments concerned," and (3) residual expenses are allocated on a base "representative of the total activity" of the company or the prescribed three-factor formula.

d. Appropriate steps must be included in all audits, i.e., price proposals, forward pricing rate proposals, defective pricing, etc., to assure that adjustments were made for the changes in the accounting practices.

e. Because changes in the home office accounting practices will normally affect more than one organizational unit of the company, arrangements should be made by the CAC, CHOA, or GAC as soon as possible to coordinate the reviews of the price adjustment proposal.

f. Auditors should encourage contractors becoming subject to the standard to submit their Disclosure Statement revisions and a pro forma submission of their revised home office expense structure as soon as possible. The early submission and review of this data could permit the contractor and auditor to resolve any

significant problems before the contract award due dates and thereby preclude delays in the awards of contracts.

g. This standard requires contractors to use a base representative of the total activity of the segments for distributing residual expenses unless the criteria for special allocation or for the three-factor formula method are met. If the residual expenses exceed the levels in CAS 403.40(c)(2), the contractor must distribute them on the basis of the three-factor formula beginning with the next fiscal year. In addition, the contractor may also choose to use the three-factor formula even though not required by the standard. The first time the contractor must use the three-factor formula, it may submit a proposal for an equitable adjustment. After the contractor uses the three-factor formula for the first time any change to the base for distribution of the residual expenses is subject to not only the provisions of this standard but also the provisions of CAS 401 and FAR 52.230-2(a)(4)(ii), (a)(4)(iii), or (a)(5). The prefatory comments to CAS 420 state that the amount of IR&D and B&P costs at a home office is not to be added to the residual pool to determine whether use of the three-factor formula is required. Where the three-factor formula is not required to be used, selection of an appropriate base should consider the effect of CAS 420.50(e)(2) which, in certain circumstances, ties the allocation of IR&D and B&P costs to the home office residual expense allocation base.

h. Unbilled costs on CPFF and T&M contracts should be included only in the operating revenue section of the three-factor formula base for allocation of residual expense under CAS 403.

i. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404 Cost Accounting Standard 404 — Capitalization of Tangible Assets

This standard establishes criteria for determining the acquisition costs of tangible assets which are to be capitalized. It does not cover depreciation or disposition of fixed assets, which is covered by

CAS 409. The standard was effective 1 July 1973 and, after the receipt of a CAS-covered contract, must be applied to all capital assets acquired during the contractor's next fiscal year.

8-404.1 General

a. The standard requires contractors to capitalize the acquisition cost of tangible assets in accordance with a written policy that is reasonable and consistently applied. The policy shall include the following:

(1) A minimum service life criterion which shall not exceed two years but which may be a shorter period.

(2) A minimum acquisition cost criterion which shall not exceed \$1,500 but which may be a smaller amount.

(3) Identification of asset accountability units to the maximum extent practical. The standard defines these units as "A tangible capital asset which is a component of plant and equipment that is capitalized when acquired or whose replacement is capitalized when the unit is removed, transferred, sold, abandoned, demolished, or otherwise disposed of." These units should be identified and separately capitalized upon acquisition. Even though they may have been separately capitalized, the units should be removed from the asset accounts at disposition.

(4) Establishment of minimum dollar amounts for the capitalization of original complements of low cost equipment and for betterments and improvements. These minimum amounts may exceed the \$1,500 limitation provided the higher limitations are reasonable in the contractor's circumstances. The primary purpose in requiring the capitalization of original complements is to assure allocation of incurred cost to applicable current and future periods. The total original complement should be treated as a tangible capital asset. Therefore, the CASB expected that a contractor will identify and control the original complement as an entity rather than account separately for each individual item which comprises the total complement.

b. The acquisition cost of tangible assets includes the purchase price adjustment to the extent practical for premiums

paid or discounts received and the costs necessary to prepare the asset for use.

(1) CAS 404.50(a)(1)(i) states that the purchase price is the consideration given in exchange for an asset and is determined by cash paid or to the extent payment is not paid in cash, in an amount equivalent to what would be the cash basis. This provision requires the recognition of the gain or loss on the trade-in. No alternative adjustment of the depreciable cost of the new asset is offered.

(2) Costs necessary to prepare the asset for use include the cost of placing the asset in location and bringing the asset to a condition necessary for normal or expected use. Where material in amount, such costs including initial inspection and testing, installation, and similar expenses shall be capitalized.

(3) Donated assets which meet the contractor's criteria for capitalization shall be capitalized at their fair value. This requirement also includes those assets donated by the Federal government.

c. Tangible capital assets constructed or fabricated by a contractor for its own use shall be capitalized at amounts which include all indirect costs properly allocable to such assets. This requires the capitalization of G&A expenses and the cost of money when such expenses are identifiable with the constructed asset and are material in amount. Application of the full costing techniques to government contract costing requires that full consideration be given to the applicability of fixed overhead including G&A expenses and the cost of money to constructed assets. Therefore, constructed tangible capital assets which are identical with or similar to the contractor's normal product should receive an appropriate share of all indirect cost including G&A expenses and the cost of money. In addition, other constructed tangible capital assets requiring significant indirect support also should be burdened with their allocable share of these supporting indirect costs including supporting G&A expenditures, where such costs are material.

d. The provisions of the standard do not apply to special tooling and special test equipment which are properly

chargeable against the contracts for which the acquisition is authorized.

e. In connection with lease agreements, contractors must determine whether they consider the acquisition to be a capital lease under FASB Statement No. 13 and subject to the standard or an operating lease under FASB Statement No. 13 and subject to the requirements of FAR 31.205-36. In either case, the CASB has stated that the reasonableness of the lease costs remains the responsibility of the acquisition agencies.

f. The standard does not extend to the specific type of records to be maintained. Therefore, contractors may continue to account for their assets on a unit basis or in logical groups in accordance with other appropriate regulations.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404.2 Illustrations

The following illustrations are intended to supplement the illustrations in paragraph 404.60 of the Standard. They are to be used as a guide in determining if noncompliance exists.

a. **Problem.** A contractor has an established policy of capitalizing tangible assets which have a service life in excess of two years and a cost of more than \$1700. It enters into a contract which makes it subject to this standard.

Solution. The contractor must change its policy to conform to the maximum limitations of not more than two years and \$1,500. If costs are affected on CAS-covered contracts in existence before the requirement for the contractor to follow this standard, they are subject to the equitable adjustment provision of FAR 52.230-2(a)(4)(i).

b. **Problem.** A contractor has an existing policy of capitalizing tangible assets which have a service life of more than one year and a cost of more than \$300. It enters into a contract which makes it subject to the standard and suggests that the capitalization policy should be changed to two years and \$1,500.

Solution. The contractor's existing policy is in conformance with the provisions of the standard. Therefore, it is not

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required to make any changes to the policy. However, if it should choose to do so, the change must be made in accordance with the provisions of FAR 52.230-2(a)(4)(ii). Under that paragraph the change may not result at any increased cost to the government.

c. Problem. A contractor has a policy of capitalizing betterments and improvements when the expenditures exceed five percent of the current replacement value of buildings or 25 percent of the current replacement value of machinery and equipment. The policy does not contain any dollar limitations.

Solution. CAS 404.40(a)(4) of the standard provides that "The contractor's policy may designate higher minimum dollar limitations . . . for betterments and improvements than the limitation established in accordance with paragraph (b)(1) of this section, provided such higher limitations are reasonable in the contractor's circumstances." Since the contractor's policy does not contain specific dollar limits, it does not comply with the standard. To correct the situation, the contractor could add specific not-to-exceed dollar limitations. Betterments and improvements whose values are in excess of the established limitations would be capitalized without regard to the percentage relationship. However, the dollar limitations established by the contractor must be reasonable in its circumstances.

d. Problem. An asset having a net book value of \$1.5 million and cash of \$1 million is given in exchange for the acquisition of a new asset commonly sold for \$2 million. The contractor's policy is to capitalize the replacement as the sum of the cash paid and the net book value of the old asset.

Solution. The contractor's policy does not comply with the standard. CAS 404.50(a)(1)(i) requires the contractor to determine the amount equivalent to the cash price. The acquisition cost in this instance would be \$2 million. The contractor is required to remove the undepreciated value of the traded asset from the asset accounts and capitalize the replacement asset for \$2 million.

e. Problem. A contractor proposes to construct a facility and install equipment for the government. The proposed price

does not include an allocation of G&A expenses or cost of money. However, G&A expenses are allocated to similar facilities constructed or fabricated by the contractor for its own use.

Solution. CAS 404 applies only to tangible capital assets acquired or constructed for the contractor's own account. Assets provided by a contractor in fulfilling contract terms are not covered by this standard. However, even though facilities contracts are not subject to CAS 404, they should be allocated G&A expense under CAS 410. In addition, cost of money should be considered an allowable cost under FAR 31.205-10.

f. Problem. The contractor manufactures Model X for the government. The contractor produces one unit of Model X for its own use. The contractor capitalized the asset at \$37,500 (\$25,000 material, \$5,000 production labor and \$7,500 overhead, reflecting the 150 percent annual overhead rate).

Solution. Model X was not capitalized in accordance with CAS 404.50(b). When constructed assets are identical with the contractor's regular product, such assets must be allocated their full share of indirect costs, including G&A expenses and cost of money. Assuming that G&A expenses, production overhead cost of money, and G&A expense cost of money rate for the year are 10%, 10% and 1% respectively, the asset should have been capitalized at \$42,180, computed as follows:

Material		\$25,000
Production Labor		5,000
Production Overhead	(150%)	7,500
Cost of Money related	(10%)	500
to Production Overhead		
Subtotal		38,000
G&A Expense	(10%)	3,800
Cost of Money related	(1%)	380
to G&A Expense		
		<u>\$42,180</u>

8-405 Cost Accounting Standard 405 — Accounting for Unallowable Costs

The purpose of this standard is to facilitate the negotiation, audit, adminis-

tration, and settlement of contracts. It contains guidelines on (1) identification of costs specifically described as unallowable, at the time such costs first become defined or authoritatively designated as unallowable and (2) the cost accounting treatment to be accorded such identified unallowable costs to promote the consistent application of sound cost accounting principles covering all incurred costs. The standard does not govern the allowability of costs which is a function of the appropriate acquisition or reviewing authority. The standard was effective 1 April 1974, and is applicable to all CAS-covered contracts awarded after that date.

8-405.1 General

a. Costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a government contract. An expressly unallowable cost is that which is specifically named and stated to be unallowable by law, regulation, or contract.

b. Costs specifically designated as unallowable or as directly associated unallowable costs in a written decision of a contracting officer pursuant to contract disputes procedures shall be identified if included or used in computing any billing, claim, or proposal applicable to a government contract.

c. Costs which are stated to be unallowable in a written decision issued by a contracting officer pursuant to disputes clause procedures are required to be identified by the contractor. This includes costs claimed by a contractor to be allowable but stated by a contracting officer in a written decision to be unallowable because the costs are not allocable costs of the contract under which they are being claimed. Therefore if the contractor fails to identify claimed costs determined by the contracting officer to be unallowable because they are not allocable, the contractor is in noncompliance and the procedures in CAS 405 should be followed. (See CAS Working Group Paper 77-13.)

d. A directly associated cost is any cost which is generated solely as a result of another incurred cost and which would not have been incurred otherwise.

e. Guidance concerning accounting for unallowable costs and directly associated costs is set forth in FAR 31.201-6.

f. The costs of any work project not contractually authorized, whether or not related to a proposed or existing contract, shall be accounted for separately from costs of authorized work projects.

g. All unallowable costs shall be subject to the same cost accounting principles governing cost allocability as allowable costs.

(1) In circumstances where these unallowable costs normally would be part of a regular indirect cost allocation base or bases, they shall remain in such base or bases. This provision is based on the concept that "... the issues concerning cost allocation and those relating to cost allowance are distinct and separate. Allowability should not be a factor in the selection or in the determination of the content of an allocation base used to distribute a pool of indirect costs. The appropriateness of a particular allocation base should be determined primarily in terms of its distributive characteristics. Any selective fragmentation of that base which eliminates given base elements for only some of the relevant cost objectives would produce a distortion in the resulting allocations."

(2) Where directly associated costs are part of an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, they shall remain in the pool and be allocated through the regular allocation process. According to the CASB, to do otherwise under these circumstances, could result in double counting.

h. The standard does not specify the nature of records required except that they be adequate to establish and maintain visibility of identified unallowable costs (including directly associated costs), their accounting status in terms of their allocability to contract cost objectives, and their cost accounting treatment. Unallowable costs do not have to be identified when, based upon considerations of materiality, the government and the con-

8-405.1h.

tractor agree on an alternate method that satisfies the purpose of the standard.

i. If noncompliances are found, the auditor must ascertain the significance of the problem and make recommendations as outlined in 8-302.7.

8-405.2 Illustrations

The following illustrations are intended to supplement those in paragraph 405.60 of the standard. They will help auditors determine if the contractor is complying with the standard.

a. **Problem.** For the past several years, an auditor has questioned the allowability of part of the costs in a contractor's business luncheon account as entertainment expenses. The final cost questioned as negotiated by the contracting officer for those years has always included a large portion of the amount the auditor recommended for disapproval. In estimating the new forward pricing and provisional billing rates, the contractor reduced the estimated rates in anticipation of similar cost questioned. The contractor rates are based on a projection of cost incurred in prior years.

Solution. CAS 405.50(c) permits the government and the contractor to agree on a method, other than specific identification, as long as that method satisfies the standard. If applicable, the Disclosure Statement should be amended to reflect this.

b. **Problem.** Another contractor under circumstances similar to those above declines to adjust the estimated forward pricing and provisional billing rates.

Solution. The auditor should report this noncompliance with the standard as described in 8-302.7.

c. **Problem.** A contractor performed some unauthorized work under a cost type prime contract. The contracting officer decided to disallow the cost (direct and indirect cost) specifically related to the unauthorized work. The contractor adjusted the accounting records and the billings to identify the unallowable production costs. However, in calculating the G&A total cost input base, the contractor excluded the unallowable contract cost. It stated that the incurred cost for unauthorized work did not affect the amount of G&A expenses incurred; con-

sequently, the contractor should be permitted to recover its total G&A expense pool.

Solution. The auditor should report this to the contracting officer as noncompliance with CAS 405.40(d) and (e).

d. **Problem.** The contractor's established practice is to include overtime premium applicable to direct and indirect labor in overhead. The contractor allocates total overhead to total direct labor. The contractor performs and separately accounts for certain direct labor associated with a work project which a government contract specifically does not authorize. Both the unauthorized and authorized projects under the contract required overtime work. The contractor computes the overhead rate applicable to final billing under the contract by including overtime premium applicable to all work projects in the overhead pool and direct labor applicable to all work projects in the base.

Solution. The contractor complies with CAS 405.40(e) since it separately accounts for costs of unauthorized and authorized work projects. Also, the contractor's overhead rate computation complies with CAS 405.40(e) which states, "Where a directly associated cost (overtime premium, in this illustration) is part of a category of costs normally included in an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect cost pool and be allocated through the regular allocation process."

8-406 Cost Accounting Standard 406 — Cost Accounting Period

The purpose of this standard is to provide criteria for selecting the time periods to be used as cost accounting periods for contract cost estimating, accumulating, and reporting. It will reduce the effects of variations in the flow of costs within each cost accounting period. It will also enhance objectivity, consistency, and verifiability and promote uniformity and comparability in contract cost measurements. The standard was effective 1 July 1974 and must be applied

in the next fiscal year after receipt of CAS-covered contract.

8-406.1 General

a. The cost accounting period used by a contractor must be either (1) its fiscal year or (2) a fixed annual period other than its fiscal year if agreed to by the government. Where a contractor's cost accounting period differs from the reporting period required by the Renegotiation Act of 1951, as amended (50 U.S.C. App. 1211-1233), the latter may be used for such reporting. All rates used for estimating, accumulating, and reporting (including public vouchers and progress payment billings) must be based on the contractor cost accounting period.

b. A transitional cost accounting period other than a year shall be used whenever a change of fiscal year occurs. It may be a period more or less than a year, but not more than 15 months.

c. Costs of an indirect function which exist for only a part of a cost accounting period may be allocated to cost objectives of that same part of the period. However, such cost must be material, accumulated in a separate indirect cost pool, and allocated on the basis of an appropriate direct measure of the activity or output of the function during that part of the period.

d. The same cost accounting period shall be used for accumulating costs in an indirect cost pool as for establishing its allocation base. However, in the prefatory comments the CASB stated that although as a matter of principle it does not agree that mismatched periods are proper, it recognizes the value of appropriate expedients where cost allocations are not expected to be materially affected. Therefore, the standard provides for the use of a different period for establishing an allocation base when agreed to by the parties if (1) the practice is necessary to obtain significant administrative convenience, (2) the practice is consistently followed by the contractor, (3) the annual period used is representative of the activity of the cost accounting period for which the indirect costs to be allocated are accumulated, and (4) the practice can reasonably be expected to provide a distribution to cost objectives of the cost

accounting period not materially different from that which otherwise would be obtained.

e. Contractors shall follow consistent practices in selecting the cost accounting period or periods in which any types of expense and any types of adjustment to expense (including prior period adjustments) are accumulated and allocated.

f. Indirect cost allocation rates, based on estimates, which are used for the purpose of expediting the closing of contracts which are terminated or completed prior to the end of a cost accounting period need not be those finally determined or negotiated for that cost accounting period. They shall, however, be developed to represent a full cost accounting period, except as provided in c. above. Additional guidance for the allocation of overhead costs in such situations is contained in 6-605c.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-407 Cost Accounting Standard 407 — Use of Standard Costs for Direct Material and Direct Labor

a. The purpose of this standard is to provide criteria (1) under which standard costs may be used for estimating accumulating, and reporting costs of direct material and direct labor and (2) relating to the establishment of standards, accumulation of standard costs, and accumulation and disposition of variances from standard costs. The standard was effective 1 October 1974 and must be followed in the next fiscal year after the award of a CAS-covered contract.

b. The standard does not cover standards used for overhead, service centers, nor preestablished measures used solely for estimating.

c. Using the standard for government contract costing is the contractor's option. Contractors are not required to establish standard cost accounting systems or use established standard cost accounting systems, intended for management purposes, for costing government work. However, they are required

to follow the provisions of the standard if they choose to cost government contracts through a standard cost accounting system.

8-407.1 General

Use of a standard cost accounting system to cost government contracts is permitted only when it meets the following criteria:

a. The standard costs must be entered into the books of account. However, properly computed variances may be allocated by memorandum worksheet adjustments rather than entered in the books of account.

b. The standard costs and related variances must be appropriately accounted for at the level of the production unit. A production unit is defined as "A grouping of activities which either uses homogeneous inputs of direct material and direct labor or yields homogeneous outputs such that the costs or statistics related to these homogeneous inputs or outputs are appropriate as bases for allocating variances." This concept of homogeneity should permit contractors a degree of flexibility in setting and revising standards on the basis of individual needs and circumstances and still provide for the proper cost assignment of variances. Under this concept a single product manufacturer would be permitted to have one labor variance account for the entire plant, while a multiproduct manufacturer would be required to have a variance account for each product line and/or for the various common part subproduct lines.

c. The practices with respect to the setting and revising of standards, use of standard costs, and disposition of variances must be stated in writing and consistently followed. The written statement of practices shall include bases and criteria used in setting and revising standards; the period during which standards are to remain effective; the level, such as ideal or realistic, at which material-quantity standards and labor-time standards are set; and conditions, such as those expected to prevail at the beginning of a period, which material-price standards and labor-rate standards are designed to reflect.

d. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-407.2 Illustrations

The following illustrations are intended to supplement those in paragraph 407.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor who manufactures radios of various configurations has established labor-rate standards and variance accounts by department; i.e., fabrication, minor assembly, final assembly, and test. The functions performed within each department are similar, the employees involved are interchangeable, and the inputs of direct material are homogeneous. Each variance account is distributed annually on the basis of the department's labor dollars. The contractor's practices are stated in writing, consistently followed, and the standard costs are entered into the books of account.

Solution. The contractor's practice complies with the standard because it meets the following requirements.

(1) The practices are written, entered into the books, and consistently followed (CAS 407.40(a) and (c)).

(2) The labor-rate standards cover employees performing similar functions within each category, and the employees are interchangeable with respect to the functions performed (CAS 407.50(a)(3)).

(3) Each department qualifies as a production unit because (1) each is a grouping of activities which use homogeneous inputs of direct material and direct labor, in this case labor with similar skills and efforts, and (2) the direct labor costs (homogeneous inputs) are an appropriate basis for allocating variances (CAS 407.30(a)(7)).

NOTE: Since the employees are interchangeable and efforts performed on the radios are similar, the allocation on the basis of direct labor dollars will result in a reasonably valid assignment of the labor rate variances (differences between actual and standard rates) among the radio configurations (units of output).

(4) Standard cost and related variances are appropriately accounted for at the level of the production unit (CAS 407.40(b) and 407.50(c)).

(5) The variances are allocated to cost objectives annually on the basis of labor cost at standard (CAS 407.50(d)(1)).

NOTE: CAS 407.50(a)(2) states, "... where only either the labor rate or labor time is set at standard, with the other component stated at actual, the result of the multiplication shall be treated as labor cost at standard."

b. Problem. Another contractor who manufactures the same general types of radios having various configurations has established labor-time standards by department; i.e., fabrication, assembly, final assembly, and test. The functions performed within each department are not materially disparate except for the fabrication and testing of A and D radio configurations. The functions required for the A and D configurations differ significantly from the others in terms of operations and complexity (complicated circuitry, finer tolerances, more detailed wiring, etc.). The employees involved are interchangeable, and the inputs of direct material are homogeneous. The labor hours required for efforts performed within the departments for each configuration of the radios differ; however, this has been recognized in establishing the standards for each configuration. The labor-time variances (difference between total department standard hours and total department actual hours) are accumulated by department and distributed annually to each configuration within each department on the basis of the department's direct labor dollars (standard labor hours at actual rates). The contractor's practices are stated in writing and consistently followed and standard cost is entered into the books of account.

Solution. The contractor's practice as applicable to the fabrication and testing departments does not comply with the standard. These departments do not qualify as production units because direct labor dollars are not an appropriate base for allocating the labor-time variance to all radios on a pro rata basis since functions performed on the A and D radios are significantly disparate from

the functions performed on the other radios. The standard's definition of production unit includes the requirement that, "... the costs or statistics relating to these homogeneous inputs or outputs are appropriate as basis for allocating variances" (CAS 407.30(b)(7)). One course of corrective action would be to subdivide the fabrication and testing departments in a manner which would permit separate accounting for the labor cost variances applicable to A and D configurations separate from the other configurations. This correction would result in establishing separate bases and would then be appropriate for allocating the separate variance accounts.

c. Problem. In a current proposal, a contractor with a standard cost system prices the bill of materials with quotations rather than with its material price standards. The contractor's written statement of practices, prepared to comply with paragraph 407.50(a)(1), states that material price standards are revised effective 1 January each year and remain in effect until the end of the calendar year. The proposed contract will be performed in the current calendar year.

Solution. The use of quotations to price the bill of materials violates CAS 401. It is inconsistent with the practice of measuring direct material cost by standards and variances. The bill of materials should be priced with the material price standards currently in effect. The amount of material price variances that will be allocated to the contract from production units should be estimated separately. [Note: There could be significant difference between the amount of material cost estimated with quotations and the amount estimated by standards and variances. A difference would result, for example, if quotations are for the quantities required for the proposed contract and standards are based on economic order quantities for all of the contractor's business.]

d. Problem. Same as c., with the exception that the proposed contract will be performed in the next calendar year. Material price standards have not been established for that year.

Solution. The use of quotations would be acceptable provided they are the basis

for estimates of next year's material price standards.

8-408 Cost Accounting Standard 408 — Accounting for Costs of Compensated Personal Absence

The purpose of this standard is to establish criteria for measuring and allocating the costs of compensated personal absences to final cost objectives. These costs include compensation paid by contractors to their employees for such benefits as vacation, sick leave, holiday, military leave, etc. The standard was effective 1 July 1975. It must be followed in the next fiscal year after receiving a CAS-covered contract.

8-408.1 General

a. The provisions of the standard require that the costs of compensated personal absence be assigned to the cost accounting period in which entitlement is earned in accordance with the contractor's plan or custom. The standard defines compensated personal absence as "any absence from work for reasons such as illness, vacation, holidays, jury duty, military training, or personal activities, for which an employer pays compensation directly to an employee." Additionally it defines entitlement as "an employee's right, whether conditional or unconditional to receive a determinable amount of compensated personal absence, or pay in lieu thereof." These conditions required many contractors which had previously recorded such costs when paid to revise their accounting practices to accrue the costs over the period during which the qualifying service was performed.

b. Entitlement is recognized on the accrual basis only in the cost accounting period in which there arises a liability to pay compensation in the event of layoff or other nondisciplinary termination of employment.

c. The standard supplements these requirements with the following clarifying comments:

(1) If the employer's plan or custom provides that a new employee must complete a probationary period before the

employer is liable to pay the employee for compensated personal absence, such service may be treated as creating entitlement, provided the contractor does so consistently.

(2) If the employer's plan or custom provides that entitlement is to be determined on the first calendar day or the first business day of a cost accounting period, entitlement will be considered earned in the preceding cost accounting period.

d. When there is no liability for payment of unused entitlement on layoff, such costs will be considered to be earned in the period in which paid. In this case, the accrual method is not permitted.

e. Each plan or custom must be reviewed individually to determine when entitlement is earned. If a plan or custom is changed, a new determination of entitlement must also be made. In reviewing each individual plan, the auditor will make use of the contractor's written policies and procedures and any prior reviews included in the FAO permanent files. However, there may be instances, particularly at smaller contractor locations, where written policies and procedures do not exist. In these circumstances, the auditor will evaluate the "custom" of the employer for paying compensation for personal absences.

f. Various contractor sources may provide the needed information for determining entitlement. Examples include personnel records and memoranda, corporate minutes relating to costs of personal absences, financial statements and accounts relating to compensation for personal absence, and the appropriate journal entries supporting the books of account.

g. The liability to be accrued is the total amount the contractor is obligated to pay for each plan in the event of layoff, notwithstanding that the employee may forfeit some or all of the entitlement if she or he were to resign voluntarily. The liability will be adjusted for anticipated nonutilization, if it is expected to be material.

(1) The use of either current wage rates or anticipated wage rates at the time of payment is permitted provided such rates are applied consistently.

(2) The standard also permits the option of calculating the accrued liability either on an individual employee basis or on a total plan basis. A contractor choosing to estimate the total cost of all employees in the plan may use sample data, experience, etc. The auditor should review the data used to assure that the classes and types of employees included are representative of the employee group during the period for which the liability is being accrued.

h. As noted previously, many contractors record costs of personal absences only when paid, but under the standard they will now be required to accrue such costs. Therefore, in the year of conversion, two years' expenses are recorded - the costs paid during the year and the accrual for costs earned during the year but to be paid in a future year. To prevent a double charge to government contracts, the standard requires contractors to defer the initial accrual through the use of a suspense account. Whenever the balance in the suspense account at the beginning of the cost accounting period exceeds the contractor's corresponding liability for compensated absence at the end of the same cost accounting period, the contractor is permitted to reduce the suspense account until it is equal to the liability. The amount by which the suspense account is so reduced becomes an additional cost of compensated personal absence for that cost accounting period.

i. There may also be instances where the contractor's practice is to accrue only a portion of the estimated liability required by the standard. In such cases, the contractor must revise its accounting practices to accrue the balance of the liability, as required by the standard. The amount of the additional accrual must be placed in a suspense account, as described above. In such cases, it should also be noted that, in comparing the amount in suspense to the year end liability, only that part of the liability which corresponds to the suspense account, i.e., the liability for benefits not recognized under the previous accounting practice, should be used.

j. If a plan or custom is changed or a new plan or custom is adopted by the employer, an initial or additional accrual

may also be required. This accrual is also to be placed in suspense. The suspense amount to be charged in each cost accounting period will be computed as described above.

k. The costs of personal absence must be allocated among cost objectives on an annualized basis, except as permitted by the provisions of CAS 406 - Cost Accounting Period. However, the allocation rate may be revised during a cost accounting period based on revised estimates of period totals.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-408.2 Illustrations

The following illustrations are intended to supplement those in paragraph 408.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor has a program whereby an employee on reaching a certain level within the management structure becomes entitled to a 3-month sabbatical vacation with pay on completion of five years of service. No entitlement to the sabbatical vests in the employee until it is actually taken. If the employee were to be terminated prior to the completion of five years, she or he would not be paid. The contractor becomes subject to CAS 408 and wishes to accrue the cost of the sabbatical vacation ratably over the 5-year eligibility period.

Solution. This contractor may not accrue the cost of the sabbatical vacation since its present policy does not meet the criteria for accrual required by CAS 408.50(b)(1). Under this provision, entitlement is recognized on the accrual basis in the same cost accounting period in which the employer becomes liable to pay compensation in the event of layoff (vested). However, under this contractor's policy, the employee would not be paid if terminated prior to the completion of 5 years. In this case, the contractor would be subject to the provisions of CAS 408.50(b)(3) which require that when no liability exists for the payment of unused entitlement on layoff, the cost of the

compensated personal absence is to be recorded in the cost accounting period in which the leave is taken and/or paid. If the contractor changed its present policy to provide for a pro rata vesting (that is, payment on a pro rata basis in the event of termination) over the 5-year eligibility period, then the accrual for the sabbatical vacation would be acceptable.

b. Problem. The contractor has a vacation plan which provides that an employee who has been employed at least one year at 31 December becomes entitled to 80 hours of vacation, starting no earlier than the following 1 May, provided the individual is still employed at that time. If the employee were to be laid off prior to 1 May 1988, he or she would be paid on 1 May 1988 for the vacation earned as of 31 December 1987. If the employee were still in layoff status as of 1 May 1989, she or he would then be paid for any vacation earned between 1 January 1988 and the date of layoff. However, if the employee were to quit voluntarily before 1 May 1988, he or she would forfeit the right to vacation pay. The contractor's fiscal year ends 31 March 1988 under CAS 408 to reflect its liability for vacation pay.

Solution. CAS 403-40(a) requires that the cost of vacation pay be assigned to the cost accounting period or periods in which the entitlement was earned. In this case, vacation was earned during the annual period ending on 31 December 1987. Although retention on the payroll or reemployment status is required to actually receive the vacation at 1 May 1988, the estimated vacation liability amount has already been determined by the preceding 31 December. In addition, CAS 408.50(b)(1) establishes the liability to be recognized as that amount of vacation pay which would be payable on

layoff, even though some employees may voluntarily terminate and forfeit their entitlement. Therefore, the contractor, in determining its liability at 31 March 1988, should include both the amount earned for service between 1 April 1987 and 31 December 1987, and the amount earned for service between 1 January 1988 and 31 March 1988. This liability should be reduced for anticipated forfeitures, if material, as required by CAS 408.50(c)(2). It should be noted that in fiscal year ended 31 March 1987, if this is the contractor's initial compliance with the standard, the contractor would have been required under CAS 408.50(d)(1) and (3) to place in suspense the excess of any accrual required by the standard as of 31 March 1987 over the amount it would have accrued under the previous accounting method and amortize such suspense account in accordance with the terms of the standard.

c. Problem. The following is an example of how to use the suspense account in a partial accrual situation: Company A has a union agreement which requires it to pay hourly employees for unused vacation on layoff. The company follows a similar custom with salaried employees, although, it is not required to do so by any written agreement. Company A's practice has been to accrue the cost of the vested vacation for the hourly employees but to recognize the cost of salaried vacations only at the time of payment. Company A must comply with CAS 408 beginning on 1 January 1986 and must revise its accounting practice accordingly.

Solution. The total vacation cost determination is shown below in the form illustrated in the standard, followed by the same calculation in columnar form, as follows:

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18-408.2c.

	Format Used in CAS 408.60		
	Hourly Employees (000)	Salaried Employees (000)	Total Employees (000)
1986 beginning liability:			
With standard	\$ 500	\$ 100	\$ 600
Without standard	500	—	500
Amount to be held in suspense (CAS 408.50(d) (1))	0	100	100
1986 ending liability	400	80	480
Plus paid in 1986	475	95	570
Subtotal	875	175	1,050
Less 1986 beginning liability	500	100	600
1986 vacation cost, basic amount	375	75	450
Amount in suspense at beginning of 1986	0	100	100
Less 1986 ending liability	0	80	80
Suspense to be written off in 1986:			
additional 1986 vacation cost (CAS 408.50(d) (3))	0	20	20
1986 basic vacation cost	375	75	450
Plus 1986 writeoff of suspense (CAS 408.50(d) (3))	0	20	20
1986 total vacation cost	\$ 375	\$ 95	\$ 470

	Columnar Format				
	Vacation Liability	Vacation Cost (000)	Cash (000)	Suspense Account (000)	Vacation Ref. Note (000)
Beginning liability without standard	\$ 500				a
Suspense account	100	—	—	\$ 100	c
Beginning liability with standard	600			100	b
1986 earned vacation	450	\$ 450			d
1986 vacation pay	570	—	\$ 570	—	e
Subtotal	480	450	570	100	b
Adjust suspense account	—	20	—	20	g
Balances, 12/31/86	\$ 480	\$ 470	\$ 570	\$ 80	f

Notes to Columnar Format
a. Represents the beginning liability amount accrued for the hourly employees under the contractor's previous method.

b. Represents the beginning liability amount accrued for both the hourly and salaried employees as required by the standard.

c. Represents the setup of the suspense amount for the increase in vacation liability for salaried vacations as required by the standard.

d. Represents the increase in liability for the total vacation cost earned by employees during the cost accounting period.

e. Represents the reduction in liability for the amount paid to employees during the cost accounting period.

f. Represents the ending liability amount for the cost accounting period as well as other account balances resulting from the transactions discussed above. The total ending liability of \$480 thousand is composed of \$400 thousand for hourly vacations and \$80 thousand for salaried vacations.

g. The amount in suspense (\$100 thousand as discussed in c. above) should be compared with that portion of the vacation liability at the end of the year, which represents the same type of expense charged to suspense account (\$80 thousand for salaried vacations as discussed in f. above). As the amount in suspense exceeds the ending liability, the excess (\$20 thousand) will be charged to the vacation cost earned during the year and the suspense account balance will be reduced by the amount of the excess.

This illustration presented one acceptable method for comparing the amount in suspense with the liability at the end of the year. Other methods, such as specific employee identification, may also provide a reasonable satisfaction of the standard's requirements. The method used should achieve a comparison of like items for authorization of the amount held in suspense.

d. **Problem.** A contractor has a fiscal year ending 31 December. Under this existing practice, the contractor begins to accrue for each holiday one year in advance. For example, the anticipated cost of holiday pay for 4 July 1987 would be accrued in 12 monthly increments beginning July 1986 and extending through June 1987. However, under the contractor's policy, entitlement for holiday pay occurs only in the cost accounting period when the holiday is taken.

Solution. The contractor's practice does not comply with CAS 408. CAS

408.40(a) requires that holiday pay be assigned to the cost accounting period in which it is earned. Under the contractor's policy, entitlement occurs when the holiday is taken. Therefore, the contractor may recognize in 1986 only the costs of holidays which occurred in 1986. It should be noted that a contractor whose fiscal year ends on 31 December may elect to recognize the costs of the 1 January holiday either in the year in which it occurs or in the preceding year, provided whichever policy is adopted, it is followed consistently.

8-409 Cost Accounting Standard 409 — Depreciation of Tangible Capital Assets

This standard provides criteria for assigning costs of tangible capital assets to cost accounting periods and should enhance objectivity and consistency in their allocation. The standard was effective 1 July 1975 and must be followed for all tangible assets acquired in the next fiscal year after receipt of a CAS-covered contract. The standard does not apply where compensation for tangible capital asset usage is based on use allowances as provided in Office of Management and Budget Circular No. A-21 and A-87 or other appropriate acquisition regulations.

8-409.1 General

a. Estimated residual values must be determined for all tangible capital assets or groups of assets. The residual values must be deducted from the capitalized value in computing the depreciable cost base, except where (1) the estimated residual value of tangible personal property does not exceed 10 percent of the capitalized cost or (2) either the declining balance method or class-life-asset-range system is used. The standard prohibits the depreciation of assets or asset groups below their residual value, including tangible personal property for which the 10 percent or less residual value was not deducted in computing the depreciable cost base. However, this does not apply to individual assets within a group where assets are accounted for by groups. The auditor should test asset values identified

on contractor depreciation schedules or tax returns to ensure that residual values are properly deducted from capitalized costs.

b. The estimated service life of the tangible capital asset, over which the depreciated cost is assigned, must reasonably approximate the actual period of usefulness to its current owner, considering such factors as obsolescence and required quality and quantity of output. The estimated service life can exclude standby or incidental use periods, provided adequate records substantiate the withdrawal of such assets from active use. Expected periods of useful life must be based on recorded past experience, as modified for expected changes in operating practices, obsolescence, or quantity of products produced. However, the contractor must justify estimated service lives which deviate from the previously experienced lives. (See CAS Working Group Paper 78-22.)

(1) The standard requires the contractor to maintain adequate records which identify the age of the asset or asset group at retirement or withdrawal from active use. The record should contain such information as asset acquisition/disposition dates, date asset was withdrawn from active service, and any other factors that directly influence asset lives. The record need not be maintained solely for fixed asset accounting; it may be a record used for such other purposes as property insurance, income/property taxes, property control, or maintenance.

(2) If supporting records are not available on the date the contractor must first comply with the standard, the estimated service lives should be those used for financial accounting. However, the required supporting records must be developed by the end of the second fiscal year after that date and used as a basis for estimated service lives on assets subsequently acquired.

(3) When a new asset is acquired for which the contractor has no available data or prior experience, the estimated service life must be based on projection of the expected useful life. The projection cannot be less than the midrange period for asset guideline classes established under IRS Revenue Procedure 72-10 and

will be used only until the required records are available.

(4) In special circumstances, contracting parties may negotiate a shorter estimated service life if it can be reasonably projected.

c. The contractor may select any appropriate method of depreciation which reflects the pattern of consumption of services over the life of the asset. For example, an accelerated method is appropriate where the expected consumption of services is greatest in the early years of the asset life. The method used for financial accounting must be used for contract costing unless it does not reasonably reflect expected consumption or is unacceptable for Federal income tax purposes.

(1) Financial accounting methods are expected to approximate the pattern of consumption of services. Therefore, if the contractor continues to use previous methods found to be acceptable to the government on similar assets for financial accounting, no additional support of existing method will ordinarily be required. The auditor, however, is responsible for ensuring that the depreciation methods generally reflect the pattern of consumption of services. Consequently, the auditor's compliance review should include limited tests of existing usage records to determine that no gross distortions in depreciation costs result from these depreciation methods. If a gross distortion is indicated as a result of that limited test, the review should be expanded to determine whether the distortion is material enough to warrant a change in the contractor's depreciation method.

(2) A depreciation method selected for newly acquired assets which differs from the depreciation method currently used for like assets in similar circumstances must be supported by the contractor's projection of expected consumption of services.

d. Depreciation costs are generally allocated as indirect costs to the cost objectives for which the assets provide service. They may be charged directly to cost objectives at average rates only if the charges are based on usage and the costs of all like assets used for similar purposes are also charged directly. Depreciation costs for assets included in service cen-

ters, where significant, must be charged to the service center.

e. Changes to estimated service lives, residual values, or consumption of services may be required as a result of significantly changed circumstances. Any resulting adjustment to the undepreciated cost will be assigned only to the cost accounting period in which the change occurs and to subsequent periods. No retroactive adjustments will be made.

f. The standard outlines the following accounting treatment for gains or losses associated with the disposition of tangible capital assets.

(1) Where the asset is disposed of without an exchange, the gain or loss is generally treated as an adjustment to the appropriate indirect expense pool in the cost accounting period in which the disposition occurs. However, the auditor should be aware that, in such circumstances, the standard limits the gain to be recognized for contract costing purposes to the difference between the asset's original acquisition cost and its net book value.

(2) Where an asset is exchanged for like property, two options are available to the contractor: either the gain or loss can be recognized as discussed above, or the depreciable cost base of the new asset may be adjusted for the entire gain or loss.

(3) Where an asset disposition results from an involuntary conversion and the asset is replaced by a similar asset, the same two options as described above for exchanges of like property are available to the contractor.

(4) Where assets are grouped, gains or losses are not recognized. Instead they are processed through the accumulated depreciation account.

g. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-409.2 Illustrations

The following illustrations are intended to supplement those in paragraph 409.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Based on a sample of asset dispositions/withdrawals for the last three years, the contractor now estimates 10 years service life for lathes. The records in the sample supporting the 10-year life classified several machines as "withdrawn from active use" although the machines are still on hand, in good working condition, and physically located in the plant machine shop. Neither the property records nor any other records reflected any change in the assets from active to inactive status. Records reflect a comparatively low usage of these specific machines for the past year due to a slack period.

Solution. The machines should not be classified as "Withdrawn from active use" unless the contractor provides adequate documentation substantiating the change in status. Machines temporarily idled for lack of work are not "withdrawn from active service." The contractor's written policies and procedures should define (1) the conditions under which capital assets may be withdrawn from active use and (2) the property records which must be prepared for processing the asset from active to inactive status. The records should clearly support that assets "withdrawn from active service" are in actuality intended only for standby or incidental use.

b. **Problem.** Contractor purchases various tangible capital assets in FY 19XX and sells them seven years later. Information pertinent to the acquisition and sale is as follows:

<u>Capital Equipment</u>	<u>Capitalized Acquisition Cost</u>	<u>Current Net Book Value</u>	<u>Sales Price</u>
Lathe	\$30,000	\$10,000	\$32,000
Truck	\$ 5,000	\$ -0-	\$ 100
Fork Lift	\$10,000	\$ 3,000	\$ 2,000

Depreciation expense over the seven years was allocated to manufacturing overhead.

Solution. The contractor will allocate gains and losses to manufacturing overhead in the year of sale as follows:

<u>Capital Equipment</u>	<u>(Gain) or Loss</u>
Lathe	(\$20,000)
Truck	(\$ 100)
Fork Lift	\$ 1,000

* Gain or loss is the difference between amount realized on disposition and its undepreciated balance (\$32,000 - \$10,000 = \$22,000); however, per CAS 409.50(j)(1), for contract costing purposes, the gain must be limited to the difference between the original acquisition cost of the asset and its undepreciated balance (\$30,000 - \$10,000 = \$20,000).

c. **Problem.** The capitalized cost of a lathe is \$50,000. The lathe is projected to have a residual value of \$4,500 and an estimated service life of 10 years. The contractor utilizes a straight-line depreciation method.

Solution. Because the \$4,500 residual value is less than 10 percent of the capitalized cost, the annual depreciation charges may be based on a depreciable cost base of \$50,000. However, since CAS 409.50(h) provides that no depreciation costs will be charged which would significantly reduce an asset below its residual value, the depreciation cost in the tenth year should be reduced to \$500, as computed below:

Depreciable cost base	\$50,000
Accumulated depreciation 9 years @ \$5,000 per year	\$45,000
10th year @ 500	<u>500</u>
	<u>45,500</u>
Net book value at end of 10th year (equals residual value)	<u>\$ 4,500</u>

8-410 Cost Accounting Standard 410 - Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

a. This standard provides criteria for the allocation of general and administrative (G&A) expenses to final cost objectives and furnishes guidelines for the type of expense that should be included in the G&A expense pool. It also establishes that G&A expense shall be allocated on a cost input base which represents total activity. Contractors presently using the sales or cost of sales allocation base have the option of changing to the cost input allocation base as soon as they become subject to the standard or selecting the special transition method described in Appendix A of the standard. Notably, the special transition method permits the continued use of the sales or cost of sales base to cost those CAS-covered contracts existing on the date the contractor is required to comply with this standard. The standard will increase the likelihood of achieving objectivity in the allocation of expenses to final cost objectives and comparability of cost data among contractors in similar circumstances.

b. The standard was effective 1 October 1976 and must be followed in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable.

c. See CAS Working Group Papers 78-21 and 79-24 for guidance issued by the CAS Working Group on CAS 410.

8-410.1 General

a. Business Unit G&A Expense Pool

(1) The G&A expenses must be grouped in a separate indirect cost pool and allocated only to final cost objectives. For an expense to be classified as G&A, it must be incurred for managing and administering the whole business unit. Therefore, those management expenses that can be more directly measured by a base other than cost input should be removed from the G&A expense pool. For example, expenses such as program management, procurement, subcontract administration, G&A-type expenses incurred for another segment, etc. should not be identified as G&A expenses. They should be the subject of a separate distribution in reasonable proportion to the benefits received. However, immaterial expenses which are not G&A may be included in the G&A expense pool. The G&A expense pool may be combined with other expenses allocated to final cost objectives if (1) the base for the combined pool is appropriate for allocating both the G&A expense pool and the other expenses, and (2) the individual and total expenses of the G&A expense pool can be identified separately from the other expenses.

(2) FAR 31.203(c) requires that G&A expenses be allocated to final cost objectives through a base that contains unallowable costs. FAR 31.203(c) states that "all items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs." The CASB has also recognized this principle in the prefatory comments to CAS 405 (last paragraph of comment no. 4) stating "the allowance or disallowance of these costs is subject to the cognizant agency's cost principles." In ASBCA Case No. 35895, the contractor challenged the Government's position

that a portion of G&A expense allocated to contracts is unallowable in the same ratio as unallowable base costs are to total base costs allocated to a contract. The issue was resolved on 28 December 1993 by the U.S. Court of Appeals for the Federal Circuit (No. 93-1025). The Court upheld the Government position, stating that FAR 31.203(c) is primarily an allowability provision which does not conflict with the CAS 410 requirement that G&A be allocated only to final cost objectives.

(3) Selling costs may be accounted for in the G&A expense pool or in a separate pool. CAS 410 takes a permissive position. It does not provide guidelines on how selling costs should be allocated. When an analysis of selling costs discloses that a significant and disproportionate amount of the activity relates to sales, CAS 410.40(d) and 410.50(b)(1) require that the costs be removed from the G&A pool and allocated on a causal or beneficial relationship to business unit cost objectives. When the inclusion of selling costs in the G&A pool results in a disproportionate allocation to the government, a noncompliance report should be issued. When the inclusion of selling costs in the G&A pool results in a disproportionate allocation which benefits the government or is insignificant, a technical noncompliance report should be issued. The technical noncompliance report should recommend that the ACO place the contractor on notice that the noncompliance will be pursued if, in the future, the noncompliant practice results in significant increased costs to the government. The report should also recommend that the ACO request the contractor to annually provide data demonstrating that there is no significant or detrimental impact on government contracts as a result of the noncompliant practice. See 7-1304 and 7-1306 for a fuller discussion on the allocability of selling costs.

(4) Home office expenses allocated to a segment may or may not be included in the segment's G&A expense pool. The standard states that allocations of line management expenses, residual expenses, and directly allocated expenses related to managing and administering the receiving segments are to be included in the G&A expense pool. Separate allocations

of home office centralized service functions, staff management of specific activities of segments, and significant central payments or accruals must be allocated to the benefiting cost objective. However, when there is no discernible causal or beneficial relationship with any of the cost objectives, these expenses may be included in the segment's G&A expense pool. When separate allocations are reflected in home office cost accounting, they must be identified in the cost transfers to the segments under CAS 403. To support that home office expenses were allocated to the segment in compliance with CAS 403, the contractor must identify the allocation base and components of the expense pool. Segments that perform both home office and operating segment functions must segregate the expenses of the home office function. These expenses must be allocated to the benefiting segments, including the segment performing the home office function. G&A expenses incurred by a segment for another segment will be removed from the incurring segment's G&A expense pool and transferred to the other segment.

(5) Any other costs which do not satisfy the definition of G&A expenses may be included in the G&A expense pool if they were previously a part of G&A and cannot be allocated to final cost objectives on a beneficial or causal relationship best measured by a base other than a cost input base.

b. Business Unit G&A Allocation Base

(1) The standard requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. The cost input base selected may be total cost input, value-added cost input, or single-element cost input. Modified bases are not permitted unless the item is an insignificant element of the selected cost input base and its exclusion does not invalidate the chosen base's representation of total activity. In the prefatory comments the term "total activity" refers to the production of goods and services during a cost accounting period. What is being pursued for the base is a flow of costs bearing a

reasonable relationship with the production of goods and services.

(a) While the standard says that, "A total cost input base is generally acceptable as an appropriate measure of total activity of a business unit," two other bases may be used when they best represent "the total activity" of the business unit. The selection of the best base involves judgments on whether inclusion of certain base costs cause "distortions" in allocating G&A to some contracts. The specific circumstances of the business unit shall be considered in determining which base best represents total activity. The ASBCA, in essence, ruled that there is no preferred allocation base to distribute G&A expenses other than the one which best represents total activity (Ford Aerospace and Communications Corporation, Aeronutronic Division, ASBCA No. 23833). The following are some examples where the value-added or single-element base may be appropriate:

1. Large subcontracts of the type that clearly contrast with arrangements which require close supervision and participation on the part of the prime contractor, for example, drop shipments. These subcontracts generally do not bear the same relationship to G&A as other cost elements. The existence of these types of contracts as a stable part of the business may be evidence that total cost input may not be an appropriate measure of total activity as it may cause an inequitable amount of G&A to be allocated to the contract with the large subcontracts. Consideration should be given to changing to a value-added base.

2. Large amounts of government-furnished material on some contracts with the same type of material purchased on other contracts. This may cause an inequitable shift of G&A to the contract with purchased materials. Consideration should be given to changing to a value-added base.

3. Contractors whose business activity is clearly labor intensive, but have contracts that include major purchasing and subcontracting responsibility on a "pass-through" basis which causes significant distortions in allocated G&A. Consideration should be given to a value-added or single element base.

4. When a contractor has demonstrated by a detailed analysis of the G&A pool elements to individual base elements, that a certain base element does not have significant causal or beneficial relationships to that G&A expense. When this is found, an analysis must be done to decide which of the three bases best measures total activity of that business unit. There may not exist one perfect base. Purifying the G&A expense pool is the best way to minimize any potential inequities which may surface in implementing a cost input base which does not perfectly eliminate distortions.

(b) Interdivisional transfers may be excluded from the receiving division's G&A base only when (1) circumstances warrant the use of a base whose constituent parts do not include material such as a value-added or a single-element base, or (2) the interdivisional receipts are not significant. Facilities contracts as defined in FAR 45.301 should also be included in the total cost input base unless the provisions of CAS 410.50(j) apply.

(c) The costs deducted from total costs to determine the value-added base should be limited to direct material and subcontract costs. FAR 15.804-6(b)(2), Table 15-2 (notes to SF 1411), under the heading of direct material, provides an authoritative definition of subcontract costs which states, "Include parts, components, assemblies, and services to be produced or performed by other than you the contractor in accordance with your designs, specifications or directions and applicable only to the prime contract." In applying this definition take care to avoid inappropriate inclusions or exclusions from the value-added base resulting from broad application of terminology or individual contractor account classifications. For example, subcontract labor of the "body shop" type often supplements the normal work force and is used interchangeably with the regular employees under the same supervisors. This work does not fit the definition of services to be performed by other than the contractor. Thus, it would be inappropriate to deduct these amounts from the total costs. On the other hand, it would be appropriate to deduct the cost of subcontracts for items such as interior decora-

tion of aircraft even though a contractor accounts for them as part of other direct costs.

(d) The criteria for use of a single-element cost input base are very specific. A single-element cost input base may be used when a contractor can demonstrate that it best represents the total activity of a business unit and produces equitable results. Thus, a single-element base, such as direct labor dollars, may be used when the direct labor dollars are significant and the other measures of activity are less significant related to total activity. The contractor should periodically analyze the single-element base to assure that it best represents total activity and produces equitable results. When other measures of activity become significant, a single-element base may not produce equitable results. A single-element base is inappropriate when it is an insignificant part of the total cost of some of the final cost objectives.

(2) Initial changes from one type of input base to another which are required to comply with the standard would be subject to equitable adjustment. For example, a contractor previously used a direct labor hour base for allocating G&A expense. On the applicability date of CAS 410, the contractor changes its G&A allocation base to total cost input because other measures of activity besides direct labor are significant in relation to total activity. Since the base change is required in order to comply with section 410.50(d), the contractor is entitled to an equitable adjustment. Once a G&A base has been selected, it should not be changed unless the underlying business activity changes. When a base change is elected, adequate notice must be given to the ACO.

(3) A special allocation of G&A expenses is permitted if a particular contract or other final cost objective would receive a disproportionate allocation of G&A expenses by using the cost input base. However, the allocation from the G&A expense pool to the particular contract or other final cost objective must be commensurate with the benefits received. It must also be removed from the existing G&A expense pool and allocation base. The CAS 410.50(j) provision is applica-

ble to a particular final cost objective which is an exception to the contractor's normal operation, rather than to classes of contracts or final cost objectives. It appears that the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation cannot be achieved by normal methods. The use of a special allocation to a particular contract or other final cost objective is the only alternative to the uniform allocation requirements of the standard. The standard does not permit the use of an abated or reduced rate for certain costs (e.g., a lesser rate for subcontract costs). Before approving a special allocation, the G&A expense pool should be carefully reviewed to purify it of any expenses which may be allocated to cost objectives more directly than by a cost input base. When a special allocation under CAS 410.50(j) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices. The description should identify not only the special allocation but also the circumstances which required it.

(4) The standard provides that work on stock or product inventory items represents part of the productive activity of the business unit for a cost accounting period, and therefore should receive an allocation of G&A expense. The costs of such items must be included in the G&A allocation base for the period in which the items are produced or worked on rather than the period in which they are issued to final cost objectives. The cost must be included only once in computing the allocation base and rate. The time these items are issued from inventory to final cost objective is irrelevant for computing the G&A base and for calculating the G&A expense rate.

(a) Where it was the previous practice of the business unit to include G&A expense as part of the product inventory, the cost of all units produced in a period should include the G&A expenses of the cost accounting period in which the items are produced, including those remaining in inventory at the end of the year. Since G&A has already been applied to items in

inventory, no additional G&A will be applied when those items are issued.

(b) If the previous practice was not to include G&A expense as part of the cost of product inventory, the business unit must consistently use one of two methods to cost G&A expenses to the cost of product inventory. The first method permits the business unit to allocate G&A to the costs of items produced for stock, including those remaining in inventory at the end of the period, using the G&A rate of the period the items were worked on. This is the same method as allowed for business units that costed G&A expense as part of the costs of product inventory. The second method permits a business unit to allocate G&A to such costs using the rate of the period the items were issued. For example, if a business unit produces 100 items for stock and issues 50 items in period 1 and 50 items in period 2, the cost of 100 items produced would be included in the allocation base of period 1. No costs for these items would be included in the allocation base of period 2. However, for purposes of allocating G&A expense to the inventory, the G&A rate of period 1 would be applied to the 50 items issued in that period, and the G&A rate of period 2 would be applied to the 50 items issued during that period. The CASB believed that the differences in the G&A rates applied to the final cost objectives by using the G&A rate of the year the items are issued rather than produced will not be material.

(c) The auditor should note that the standard only covers the treatment of items produced for stock after the applicability date. It does not cover the treatment of items held in inventory on the first date the contractor must apply the standard. Therefore, items produced for stock and included in inventory on the date the standard becomes applicable should be included in the G&A allocation base of the period in which the items are assigned to final cost objectives.

(5) Questions have been raised as to the relationship between CAS 410 and the methods used by contractors with parts cost accounting systems to transfer Work-in-Process (WIP) to cost of sales. CAS 410 addresses the application of

¶8-410.1b.

G&A expense to WIP cost input but does not prescribe the cost methods for relieving WIP and charging cost of sales. To comply with CAS 410, a contractor with a parts cost accounting system must compute a fiscal year cost input G&A expense rate to allocate G&A expenses to WIP cost input. However, the contractor may use any inventory valuation method recognized under generally accepted accounting principles, such as FIFO or average, to transfer costs including G&A expense from WIP to cost of sales.

c. If noncompliances are found regarding either the G&A expense pool or the allocation base, the auditor should ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-410.2 Illustrations

The following illustrations supplement those in paragraph 410.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. Problem. Division X excludes from its total cost input base, the cost of intercompany transfers from Division Y.

Solution. The intent of the standard is that all actions which represent the total productive activity of the segment should be included in total cost input. The costs of the intercompany transfers should, therefore, be included in the total cost input base used to allocate G&A expenses. Division X's exclusion of the intracompany transfers from the base does not comply with the standard.

b. Problem. Division X uses a total cost input base. In making its product there is extensive amount of costs for ODC, material, subcontracts, consultants, and special tooling. As these costs are all represented in approximate proportions on all of Division X's contracts, total cost input has been considered the best measure of the division's total business activity. The contractor is now contemplating entering a new business area. New contracts are planned to be bid in 1988 and may have up to 60 percent of their value in subcontracting of the type that clearly contrasts with arrangements which require close supervision and participation on the part of the prime con-

tractor, for example, drop shipments. Because of the dollar value of these contracts (\$50 million) and anticipated follow-on effort compared to Division X's normal contracts (\$150 million), the G&A allocated to the new contracts on a total cost input base would far exceed the beneficial relationships to these contracts. Division X notifies the ACO and the auditor at the beginning of 1987 that they intend to change their base to value-added. They subsequently change their Disclosure Statement to show the prospective G&A allocation base.

Solution. Division X's criteria for base selection complies with that contained in CAS 410, and the choice of the value-added base complies with the standard. However, this example is only hypothetical. Auditors must exercise professional judgment in assessing each situation individually. No two circumstances are the same.

c. Problem. Contractor Z has a number of contracts with large amounts of subcontract costs. The contractor does not believe that the use of the regular G&A rate for the subcontract costs is equitable because the subcontracts do not benefit from all of the G&A pool costs in the same relationship as the other base costs. It is therefore proposing a reduced G&A rate for the subcontract costs.

Solution. The contractor's proposal of a reduced G&A rate for the subcontract costs is in noncompliance with the standard. The only alternative to the uniform allocation requirements of the standard is the special allocation procedures which pertain to particular contracts or other final cost objectives. Special allocations to classes of contracts or to specific cost elements or types of expenses are not permitted by the standard.

8-411 Cost Accounting Standard 411 — Accounting for Acquisition Costs of Material

a. This standard provides criteria for the accounting of acquisition costs of material, provides guidance on using inventory costing methods, and improves the measurement and assignment of costs to cost objectives.

b. This standard does not cover accounting for the acquisition costs of tangible capital assets nor accountability for government-furnished materials.

c. The standard was effective 1 January 1976, and must be applied to all materials purchased or produced in the next fiscal year after receipt of the CAS-covered contract to which the standard is applicable.

8-411.1 General

a. The standard requires contractors to accumulate the cost of material and allocate it to cost objectives according to written statements of accounting policies and practices.

b. The end use of a category of material must be identified at the time of purchase or production if the cost is to be allocated directly to a cost objective. A category of material may be allocated directly even though the company maintains an inventory of this material, as long as the cost objective was specifically identified and the cost allocated at the time of purchase or production. Thus, units of a category of material could be allocated at different costs to the same cost objective, that is by direct allocation and issuance from inventory. The auditor should assure that the contractor's written statements of accounting policies and practices for accumulating and allocating costs of materials clearly set out (1) the specific conditions under which these costs may be directly allocated to cost objectives and (2) the inventory costing method to be used for allocating material costs issued from inventory. During regular audits of material, following the procedures in 5-710.1, these written statements will enable the auditor to determine that the contractor's practices comply with the standard and that deviations from the standard (which may arise as a result of contractor actions) are reported.

c. Materials used solely in performing indirect functions or which are not a significant element of production cost may be allocated to an indirect cost pool. However, when the ending inventory significantly exceeds the beginning inventory of such material in an indirect cost pool in relating to the total cost included in the indirect cost pool, the pool should

be credited for the unused portion and an asset account established for a like amount. The standard does not require the contractor to take a physical count of the ending inventories for these indirect materials. However, in the absence of a physical inventory, the auditor should make certain that a reasonable method for estimating the cost of unconsumed indirect materials at year end has been used.

d. All materials, except those directly allocated to final cost objectives (CAS 411.40(b)) and those allocated to an indirect cost pool (CAS 411.40(c)), must be accounted for in material inventory records. "Material inventory record" means any record for accumulating the cost of material for issue to one or more cost objectives. Such records need not be general or subsidiary ledger accounts but may be card files, computer data, bin tags, or any other such informal record. The written statement of accounting policies and practices should describe a material inventory record and explain how it is used.

e. When issuing material from a company-owned inventory, any of the following inventory costing methods are acceptable, provided the same costing method is consistently used for similar categories of material within the same business unit:

- (1) The first-in, first-out (FIFO) method.
- (2) The moving average cost method.
- (3) The weighted average cost method.
- (4) The standard cost method.
- (5) The last-in, first-out (LIFO) method.

f. Material cost is the acquisition cost of a category of material. The purchase price must be adjusted by extra charges incurred or discounts and credits earned. These adjustments must be charged or credited to the same cost objective as the material price; when this is not practical, charges or credits may be included in an appropriate indirect cost pool, provided this practice is consistent.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-411.2 Illustrations

The following illustration is intended to supplement those in paragraph 411.60 of the standard. It should assist as a guide in determining whether a contractor's practices comply with the standard.

Problem. A contractor's written statements of accounting policies and practices provide that the cost of a category of material used solely in performing an indirect function will be allocated to an indirect cost pool when the material is received. The contractor does not estimate the cost of unconsumed indirect materials at year end, nor does it compare this ending inventory cost with the cost of the beginning inventory of indirect materials to determine if the excess is significant in relation to the total cost included in the indirect cost pool. All costs of indirect material allocated to the indirect cost pool during the cost accounting period remain in the indirect cost pool at year end.

Solution. The practice does not comply with CAS 411.40(c). The contractor must determine the significance of the excess of the ending inventory over the beginning inventory of such materials in relation to the total cost included in the indirect cost pool. If significant, the indirect expense pool must be credited and an asset account established in a corresponding amount.

8-412 Cost Accounting Standard 412 — Composition and Measurement of Pension Costs

a. This standard establishes the composition of pension costs, the basis of measurement, and the criteria for assigning pension costs to cost accounting periods. CAS 413 addresses the accounting treatment of actuarial gains and losses and the allocation of pension costs to segments of an organization.

b. The standard is basically compatible with the Employee Retirement Income Security Act of 1974 (ERISA), although some of its provisions may be more restrictive than ERISA funding requirements. The fundamental objectives of CAS 412 differ from the objectives of ERISA. ERISA is primarily a funding

law; it is designed to ensure financial integrity of pension plans through minimum funding standards. CAS 412 was promulgated to ensure that pension costs are properly measured and allocated to cost objectives.

c. The standard was effective 1 January 1976 and must be followed in the next fiscal year after receiving a CAS-covered contract to which the standard is applicable.

d. FAR 31.205-6(j)(2) makes CAS 412 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 412.

8-412.1 General

a. The CASB defined a pension plan as a deferred compensation plan, established and maintained by one or more employers, to provide for systematic payment of benefits for life (or life at the option of the employees) to participants after their retirement. There are basically two kinds of pension plans: defined contribution plans and defined benefit plans. A defined contribution plan provides benefits to retirees according to the amount of the fixed contribution to be made by a contractor. The standard provides that the following types of plans shall be treated as defined contribution plans: (1) plans which are funded through permanent insurance or annuity contracts, (2) multi-employer plans established under collective bargaining agreements, and (3) state pension plans applicable to colleges or universities. In a defined benefit plan, the contributions to be made by the contractor are calculated actuarially to provide preestablished benefits. The cost of benefits under a pay-as-you-go plan must be measured in the same manner as the costs under a defined benefit plan. The auditor's compliance review should identify the types of all pensions plans in effect at the contractor locations.

b. Under the defined contribution plan, the pension cost of a cost accounting period is the net contribution required to be made, after adjustment for

dividends and other credits. For a defined benefit plan the pension cost for a period may consist of four elements:

(1) Normal cost (annual cost attributable to years after a particular valuation date).

(2) Amortization of the unfunded actuarial liability (excess of the actuarial liability over the value of the pension fund assets).

(3) Interest equivalent on the unfunded actuarial liability and actuarial gains or losses being amortized.

(4) Adjustment for actuarial gains and losses (differences between forecasted assumptions and actual experience).

c. The unfunded actuarial liability, if identified in the accounting records, will be amortized in equal installments over a period of not less than 10 and not more than 30 years (40 years if the plan predates 1 January 1974). If amortization has begun before the applicability date of the standard, the amortization period need not be changed. An interest equivalent on the unpaid balance of the liability must be included with each installment. Contractors must establish a policy for amortizing unfunded actuarial liabilities. When selecting the specific amortization period with the above limits, the contractor's amortization policy may give consideration to the size and nature of the unfunded actuarial liability as a component of pensions costs. The amortization policy, once established, must be consistently followed.

d. During the compliance review, the auditor should determine that these requirements are compatible with the block checked on item 7.1.6—"Amortization of the Past Service Costs" of the contractor's Disclosure Statement. Item 7.1.6 should be reviewed to determine that any changes in amortization periods which are required by the standard are properly reflected in the Disclosure Statement. CAS 412.50(a)(3) requires a contractor to establish and consistently follow a policy for selecting specific amortization periods for unfunded actuarial liabilities.

e. Pension costs applicable to prior periods which were specifically unallowable under then-existing contractual provisions should be separately identified and excluded from an amortization of un-

funded liability or from future normal costs if the unfunded liability is not identified. Also excludable from pension costs are excise taxes and interest costs incurred as a result of inadequate or delayed funding.

f. Actuarial methods used by contractors include the accrued benefit cost method and five principal projected benefit cost methods: entry age normal, attained age normal, individual level premium, frozen initial liability, and aggregate. A major difference between methods is that, under the accrued benefit cost method, costs are based on units of future benefits which have been accrued to employees to the present date; whereas, under the various projected benefit methods, costs are based on benefits which will accrue over the entire expected period of credited service of the individuals involved. Projected benefit cost methods are subdivided into individual and aggregate methods. An individual benefit method develops an annual cost accrual based on a summation of the amounts computed for each plan participant. The aggregate cost method, however, develops an annual cost based on averages of accruals for all participants. The standard does not require the use of a specific actuarial cost method; however, the method selected by the contractor must provide for separate measurement of the pension cost elements listed in paragraph b. above. The cost elements are identified under the accrued benefit method and some of the projected benefit cost methods. They are not identified under certain methods, which neither disclose actuarial gains and losses nor develop the amount of unfunded liability. If the projected benefit cost method used does not separately measure the cost elements, FASB No. 87, *Employers Accounting for Pensions*, does not permit its use for financial accounting purposes and it would not be acceptable under CAS 412.50(b)(2)(i). The effective dates for FASB No. 87 are (i) fiscal years beginning after 15 December 1986 for most contractors, or (ii) fiscal years beginning after 15 December 1988 for certain foreign concerns and for defined benefit plans of employers that are nonpublic, enterprises and sponsor no defined benefit plans with more than

100 participants. Until the contractor with plans that do not separately identify the cost elements is required to change its accounting practice to comply with FASB No. 87, the method will be considered acceptable only if:

(1) The method is used for financial accounting.

(2) An alternative computation is made (under a projected benefit cost method - i.e., entry age normal - which separately identifies normal costs, unfunded actuarial liabilities, and actuarial gains and losses) to disclose the funding status of the plan and pension costs assigned to the cost accounting period are reduced by any excess funding. The plan is excessively funded if the value of the pension fund assets exceed the actuarial liability.

(3) Supplementary records are maintained to identify actuarial gains and losses and show their disposition.

(4) The cost of future benefits is spread over the remaining average working lives of the work force.

g. The auditor's compliance review should identify the actuarial method used by the contractor for each plan in effect. The auditor should review actuarial reports and statements, as well as accounting records. If projected benefit methods are used which do not separately identify the pension cost elements, the auditor should review the contractor's proposed procedure for developing the supplementary records and the computations made thereunder, until the contractor is required to comply with FASB No. 87. (See h. above.) Indications that the contractor may not be able to develop the supplementary data on a timely basis should be promptly reported to the ACO. If the contractor has previously filed a Disclosure Statement, the auditor should determine that the block checked for items 7.1.3-"Actuarial Cost Methods" complies with the provisions of the standard. Blocks "B" through "G" of item 7.1.3 represent variants of projected cost methods which will trigger the visibility requirements in CAS 412.50(b) of the standard. If response "B-Aggregate," "C-Attained" Age-Initial Liability Frozen," "E-Entry Age-Initial Liability Frozen," or "G-Individual Level Premium" are checked, the alternative computation and

supplementary information requirements of CAS 412.50(b)(2) will be applicable. The Individual Level Premium method referred to in this paragraph is the method without separate identification of a supplemental liability. The auditor should determine what accounting practice changes the contractor will make to comply with FASB No. 87.

h. The normal costs computed under the accrued benefits cost method are the present value of future benefits earned by employees during the year. The projected benefits cost methods shall base normal costs on a percentage of payroll where the benefits are a function of salaries and wages; otherwise, normal costs shall be based on employee service or headcount.

i. While pension costs must be based on the provisions of existing plans, contractors may consider (1) salary projections for plans whose benefits are based on salaries and wages and (2) improved benefit projections for plans specifically providing for such improvements.

j. Actuarial assumptions are related to (1) interest or return on funds invested and (2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits. Each actuarial assumption used by the contractor in calculating pension costs must be identified separately. The assumptions should represent the contractor's estimated future experience based on long-term trends to avoid short-term fluctuations. The validity or the reasonableness of the actuarial assumptions can be measured in the aggregate of gains and losses rather than by a separate gain or loss analysis for each assumption. However, if the assumptions prove to be unreasonable in total; that is, the total gain or loss is significant, the contractor must be able to identify the major causes and give reasons for either retaining or revising the assumptions. If the actuarial assumptions are revised, any resulting increase or decrease in the unfunded actuarial liability will be amortized over not less than 10 or more than 30 years. Support for each actuarial assumption used by the contractor should be critically examined by the auditor. The compliance review should include steps to identify and evaluate the

reasonableness of the assumptions and to monitor actuarial gains and losses to assure that the assumptions remain valid.

k. Pension costs computed for a cost accounting period are assignable to that period only, except when a payment deferral has been granted under the provisions of ERISA. ERISA permits a contractor which has received a funding deficiency waiver for a particular year to amortize related pension costs over the immediately succeeding 15 years. Pension costs deferred to future periods under this provision must be assigned to the periods in which the funding actually takes place. However, in accordance with the first sentence of FAR 31.205-6(j)(3)(iii) and CAS 412.50(a)(7), the interest equivalent on the unfunded actuarial liability which results from this delayed funding would be unallowable.

l. Except for pay-as-you-go plans, the cost assignable to a period is allocable to cost objectives of that period if (1) costs are funded in the period or (2) funding can be compelled. Costs will be considered funded for a period if payment is made by the Federal income tax return due date, including any extension. Funding provisions in ERISA, contractual funding agreements, or existence of third-party rights to required funding would constitute evidence that funding can be compelled. Excess funding is considered applicable to future periods.

m. Pay-as-you-go plans are different from trustee or insured plans in that they are not funded. Therefore, the cost of benefits under a pay-as-you-go plan shall be measured the same as costs of defined benefit plans whose benefits are funded. Costs assignable to a period under a pay-as-you-go plan are allocable to the cost objectives of the period only if the payment of benefits is made in that period or can be compelled. If payment is optional with the contractor, costs allocable to cost objectives of the period are the lesser of the amount of benefits actually paid to beneficiaries in that period or the amount computed as assignable to that period.

n. FAR has retained the requirement that pension contributions be funded in order to be allowable. Therefore, even though the standard provides criteria for

measurement and assignment of pension costs, the auditor will continue to establish the allowability of pension costs in accordance with FAR requirements.

o. In accordance with FAR 52.230-5, a contractor is required to describe to the ACO the kind of changes made because of the new standard. The description should be submitted 60 days after the award of a contract to which the standard is applicable. This should be done whether or not the contractor has filed a Disclosure Statement. If it appears that accounting changes will be required as a result of CAS 412, and the contractor has not submitted the description on time, the auditor should advise the ACO.

p. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-412.2 Waiver

As a result of changes in the IRS definition of full funding under the Omnibus Budget Reconciliation Act (OBRA) of 1987 (P.L. 100-203), some government contractors' pension plan costs computed in accordance with CAS 412 could exceed the IRS full funding limitation (see 7-606.1.d.). To temporarily mitigate this conflict, on 8 April 1991 the new CASB authorized Federal procuring agencies, on a case-by-case basis, the authority to waive the cost assignment provisions of CAS 412.40(c) in instances in which the overfunded status of qualified plans precluded Federal tax deductibility of contributions or would cause the incurrence of a 10 percent excise tax on the overfunding. The intent of the waiver authority is to permit reassignment of those pension costs, for which funding could not have been made without foregoing tax deductibility and incurring a 10 percent excise tax, to the next subsequent fiscal period in which funding can reasonably and equitably be accomplished. Auditors should recommend to the Administrative Contracting Officer that contractor requests for a temporary waiver include an advance agreement addressing the government's right to adjust contract prices downward to recover any pension costs recognized in contract pricing, but not incurred due to the reassign-

ment of pension costs authorized by a waiver.

8-412.3 Illustrations

The following illustrations are intended to supplement those in paragraph 412.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. Problem. A contractor uses the aggregate cost method for computing and funding the \$2.3 million pension costs assignable to the period. Since the aggregate method does not provide the cost visibility required by the standard, the contractor, for the fiscal year just ended, made the alternative calculation using the entry age normal method and provided supplementary information on actuarial gains and losses. The contractor's analysis disclosed that at fiscal year end (1) the value of the pension fund assets was \$12.6 million, (2) the actuarial liability was \$10 million, and (3) the experienced actuarial gain for the period was \$1 million.

Solution. According to CAS 412.50(b)(2), the pension cost to be allocated to contracts for the cost accounting period is \$-0-, because the amount of overfunding (\$2.6 million) exceeds the computed cost for the period (\$2.3 million). Furthermore, the significance of the experienced actuarial gain would indicate that the actuarial assumptions may not be reasonable. The contractor should be required, according to CAS 412.50(b)(7), to identify the actuarial assumptions which were responsible for the gain and to provide rationale for either retaining or revising those assumptions.

b. Problem. As a result of a temporary cash shortage, a contractor's payments into the pension fund were not adequate to meet the ERISA funding requirements for the period. A 5-percent excise tax on the accumulated funding deficiency was therefore assessed against the contractor. In computing the pension cost for the fiscal year, the contractor included the assessment of the 5-percent tax plus an interest equivalent on the unpaid amount.

Solution. Both the excise tax, which was assessed as a penalty for the delayed payment, and the interest equivalent on the delayed payment should be excluded from the pension costs allocated to government contracts according to CAS 412.50(a)(6) and (7). The CASB, in its prefatory comments to the standard, acknowledged that an interest equivalent should be recognized to determine whether a pension plan is properly funded. However, since interest resulting from delayed funding is caused by a management decision to use funds for other purposes, the interest should be considered as investment cost rather than a component of pension cost.

8-413 Cost Accounting Standard 413 — Adjustment and Allocation of Pension Cost

a. This standard establishes criteria for (1) assigning actuarial gains and losses to cost accounting periods, (2) valuing pension fund assets, and (3) allocating pension costs to segments.

b. Provisions in the standard are somewhat more stringent than ERISA requirements, concerning frequency of actuarial valuations and methods of valuing pension fund assets. Consequently, some accounting changes may be required for compliance with the standard in addition to those which were previously made to comply with ERISA.

c. FAR 31.205-6(j)(2) makes CAS 413 applicable to all contracts, even contracts which are not CAS-covered or are subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 413.

d. CAS 413 was effective 10 March 1978 and must be followed in the next fiscal year after award of a CAS-covered contract to which it is applicable.

8-413.1 General

a. Actuarial gains and losses represent differences between actuarial assumptions and actuarial experience. As previously noted in 8-412.1j, actuarial assumptions are related to (1) interest or

return on funds invested and (2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits. CAS 413 requires that actuarial gains and losses for defined benefit plans be calculated annually and assigned to current and subsequent cost accounting periods, as follows:

(1) For pension plans whose costs are determined by an immediate gain actuarial cost method, gains and losses that are material will be amortized equally over 15 years beginning with the current period. The annual installment will include an interest equivalent on the unamortized balance at the beginning of the period. Immaterial gains or losses may be assigned to the current period. An immediate gain method is one in which actuarial gains and losses are determined separately as an adjustment to the unfunded actuarial liability. Included in this category are the accrued benefit and entry age normal (sometimes referred to as the individual level premium with supplemental liability) actuarial cost methods.

(2) For pension plans whose costs are determined by a spread gain actuarial cost method, actuarial gains and losses will be included in current and future normal cost and spread over the remaining average working lives of the work force. The following projected benefit actuarial cost methods all fall into the spread gain category: aggregate, entry age normal-frozen initial liability, individual level premium without supplemental liability, and the attained age normal. These methods do not separately identify actuarial gains and losses but rather include them automatically in determining normal costs. However, CAS 412.50(b)(2)(iii) requires contractors to accumulate supplemental information identifying these actuarial gains and losses. FASB No. 87, Employers Accounting for Pensions, does not permit the use of this method for financial accounting; therefore, it would not be acceptable under CAS 412 or 413. (See 8-412.1f. for details and effective dates.)

b. The standard permits use of any recognized method for valuing pension fund assets used in measuring pension cost components provided it reflects ap-

preciation and depreciation of pension fund assets and is used consistently from year to year. The illustration in CAS 413.60(b) identifies some commonly used asset valuation methods:

Type of Asset	Basis for Valuation
Equity securities and debt securities not expected to be held to maturity	5-year moving average of market values
Debt securities expected to be held to maturity	Amortization of differences between cost at purchase and par value at maturity
Real Estate	Cost less accumulated depreciation

If the method produces a value of less than 80 percent or more than 120 percent of market value, the asset values in a given year must be adjusted to the nearest 80 percent or 120 percent boundary. The adjusted asset values are then considered in calculating the actuarial gain or loss subject to the amortization criteria described above. The standard's provisions regarding the valuation of assets do not apply to plans funded with insurance companies via contracts with guaranteed benefits.

c. Except where certain significant disparities in actuarial factors exist between segments, contractors have the option to calculate pension costs either separately for segments or on a composite basis for allocation to segments on a base which represents the factors used in computing pension benefits. Separate calculations of pension costs for each segment are acceptable. CAS 413.50(c)(2) and (3) provide that pension costs must be separately calculated for a segment (on a prospective basis) when the pension costs at the segment are materially affected by any of the following conditions:

(1) The segment experiences material termination gains or losses.

(2) The level of benefits, eligibility for benefits, or age distribution is materially different for the segment than for the average of all segments.

(3) The aggregate of actuarial assumptions for termination, retirement age, or salary scale is materially different for the segment than for the average of the segments.

78-413.1c.

(4) The ratios of assets to actuarial liabilities for merged segments are different from one another after applying the benefits in effect after the merger. Differences between segments as to level of benefits and eligibility of benefits should be obtainable from the provisions of the pension plan. Segment data for termination experience, age distribution, and actuarial assumptions for termination, retirement age or salary scale will generally not be included in actuarial reports, CPA reports, Schedule B to IRS Form 5500 or other pension source documents. Thus, the auditor should attempt to gain an understanding at the onset of the pension review as to the segment data to be provided by the contractor which are necessary for audit determination of compliance with CAS 413.50(c)(2) and (3).

d. When separate pension fund calculations are required because of disparities in termination gains or losses, level of or eligibility for benefits, or actuarial assumptions for termination, retirement age or salary scale, undivided pension fund assets must be initially allocated to the segment for which the separate calculation is being made. The value of the pension fund assets allocated shall equal the segment's pension fund contributions, adjusted for earned interest and paid benefits/expenses, if such information is determinable; if not, the assets can be allocated among segments on any ratio which is consistent with the actuarial cost method(s) used to compute pension costs. The initial allocation of assets to merged segments must be the market value of the segment's pension fund assets when the merger occurred.

e. Employees participating in a multi-segment pension plan occasionally transfer between segments. However, the applicable pension fund assets and liabilities need not follow the employees from one segment to the other unless the transfers involve such a large number of employees that a segment's ratio of fund assets to actuarial liabilities would be distorted.

f. Contractors who separately calculate pension costs for one or more segments have the option of establishing a separate segment for inactive participants (e.g.,

retirees). If this action is taken, the pension fund assets and actuarial liabilities should be transferred to the inactive segment when employees participating in the pension plan become inactive. The funds transferred are to reflect the funded portion of the inactive participants' actuarial liability. CAS 413.50(c)(1) and 413.50(c)(9) provide that inactive segment costs shall be allocated to the segments with active lives on a basis representative of the factors upon which pension costs are based. Thus, pension cost calculated for the inactive participants should be allocated to the segments with active lives on a basis which is relatively comparable to the amounts that would have been computed if a separate segment for inactives had never been established.

g. When a segment is closed, the contractor must determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment as of the closure date. Although this difference represents an adjustment of previously determined pension costs, the contractor should make a refund or give credit to the government for its equitable share in the cost accounting period of closure, not prior cost accounting periods.

h. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-413.2 Illustrations

The following illustrations are intended to supplement those in paragraph 413.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Contractor X was acquired by Contractor Y and renamed Segment B. The entire work force of X was retained by Y following the acquisition. Pursuant to terms of X's pension plan, X employees were paid all vested pension benefits at the time of dissolution of X. The employees, upon coming to work for Contractor Y, were considered "new employees" with no actuarial liability attributable to their past service with Contractor X. Contractor Y's unfunded actuarial

liability (UAL) at the time of the merger was \$25 million. Contractor Y has consistently made a composite pension cost calculation for all of its segments and wishes to continue doing so.

Solution. Since Y's pension plan had a disproportionately larger UAL than X's plan at the time of acquisition (i.e., \$25 million vs. -0-), any combining of assets and actuarial liabilities of the two plans would result in a materially different pension cost allocation to Y's segments than if pension costs for Segment B were computed as though it had a separate pension plan. Pension costs must be calculated separately for Segment B.

b. **Problem.** Contractor X computes pension costs separately for Segments A, B, and C. As permitted in CAS 413.50(c)(9), the contractor elects to establish a separate segment for inactive plan participants. Pension costs for the inactive segment are allocated back to A, B, and C on the ratios of the remaining working lives of the work force of the three segments. This method results in the following allocation of inactive segment pension costs:

	Costs	%
Segment A	\$ 2.5 million	25%
Segment B	4.0 million	40
Segment C	3.5 million	35
Total inactive segment costs allocated	<u>\$10.0 million</u>	<u>100%</u>

The actuarial report discloses that the inactive plan participants retired from the following segments:

Segment Retired From	Number of Retirees	%
A	5950	85%
B	350	5
C	700	10
<u>7000</u>	<u>100%</u>	

Due to the geographical dispersion of the three segments, few employees had transferred among segments prior to retirement. The high ratio of retirees from Segment A was attributable to a major plant layoff which had occurred 10 years previously.

Solution. The contractor's allocation of inactive segment costs to Segments A, B,

and C results in a substantially different amount than would have been allocated if a separate segment for inactive participants had never been established. The auditor should recommend an allocation of inactive segment costs to A, B, and C based on the ratios of the number of retirees from each segment to total retirees.

8-414 Cost Accounting Standard 414 — Cost of Money as an Element of the Cost of Facilities Capital

a. The standard recognizes the cost of facilities capital as a contract cost. It provides criteria for measuring and allocating an appropriate share of the cost of money which can be identified with the facilities employed in a business.

b. The effective date of this standard was 1 October 1976. Contractors must follow its requirements on all contracts subject to CAS negotiated on or after this date.

c. CAS 414 and the FAR cost principle do not apply to facilities where compensation for the use of the facilities is based on use rates or allowances in accordance with Federal regulation. Where contractors are compensated for some facilities by use rates and others by depreciation, the contractor should apply CAS 414 to those facilities which are being depreciated.

d. FAR 31.205-10 makes CAS 414 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money, where significant, are in compliance with the provisions of CAS 414.

e. DFARS 215.871, "Production Special Tooling and Production Special Test Equipment (PST/PSTE)," requires that the contracting officer compute a cost of money amount for the unamortized portion of PST/PSTE costs and include them in the price of the instant contract. The cost of money computation is based upon the time period between the initial contract award and the next contract award for which PST/PSTE costs will be reimbursed. FAR 31.205-10 and CAS 414

require that the cost of money be allocated to contracts that benefit from the facilities' use. DFARS 215.871-5(b) applies to the time period between the initial and second contract awards; during this time period there is only one benefiting contract, i.e., the initial contract. Thus, by allocating the cost of money directly to the initial contract, the DFARS provision achieves the result required by FAR 31.205-10/CAS 414.

f. See CAS Working Group Papers 77-18 and 77-19 for guidance issued by the CAS Working Group on CAS 414.

8-414.1 General

a. The CAS 414 techniques must be used to compute the cost of money in connection with individual price proposals, forward pricing rate agreements, and with the establishment of final indirect cost rates. The cost of money is an imputed cost which is identified with the total facilities capital associated with each indirect cost pool, and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool. The cost of money may be considered an indirect expense associated with an individual cost pool but separately identified. The cost of money is subject to all the same allocation procedures as any other indirect expense which is allocated on a selected base, and each element of such base, whether allowable or unallowable, should bear its pro rata share of the cost of money.

b. Use of the cost of money factors in final indirect rate determinations and forward pricing proposals is discussed in paragraphs c.(4) and d. below. The calculation of the cost of money for each contract involves several steps.

(1) The average net book value of facilities for each indirect expense pool having a significant allocation of facilities is identified from accounting data used for contract costing.

(2) The cost of money devoted to facilities capital for each indirect expense pool is the product of these net book values multiplied by the cost of money rates per the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters).

(3) Facilities capital cost of money factors are computed by dividing the cost of money for each pool by the corresponding allocation base. The allocation bases used in this computation must be compatible with the bases used for applying indirect costs in determining contract costs.

(4) The cost of capital committed to facilities is separately estimated, accumulated, and reported for each contract. Each contract's share of the facilities capital cost of money is determined by multiplying the portion of the allocation bases for each indirect expense pool applicable to the contract by the facilities cost of money factor for that pool and adding the products together.

c. The facilities capital cost of money factors, wherever applicable, must be computed in accordance with the CASB-CMF form, Facilities Capital Cost of Money Factors Computation. The requirements of CAS 414 and DFARS Subpart 230.70 should be used in evaluating the contractor's submission.

(1) On the CASB-CMF form, facilities capital items are classified as Recorded Facilities, Leased Property, and Corporate or Group Facilities. Capital leases are to be considered as Recorded Facilities for purposes of the CASB-CMF form. Operating leases, for which constructive cost of ownership is allowed in lieu of rental costs under government acquisition regulations, are to be classified as Leased Property. Since cost of money would be an allowable cost if the contractor had purchased the property, the cost of money should be included as an ownership cost in determining whether the allowable cost will be based on constructive ownership cost or leasing cost. Land which is an integral part of the leased facility is subject to the same treatment as the leased facility in computing the cost of money. Land leases for which the land is used in the regular business activity will also be included on the form even though land lease costs themselves do not generate allowable costs.

(2) Facilities costs are further identified on the CASB-CMF as either "distributed" or "undistributed." Distributed facilities are those capital items which can be identified in the contractor's rec-

ords as solely applicable to those specific indirect expense pools for which a cost of money rate is to be computed. Undistributed items, which represent the remainder of the business unit's facilities capital, consist primarily of items charged to service centers. Under the regular method, undistributed assets are allocated to the appropriate indirect expense pools on a basis that approximates the actual absorption of depreciation/amortization of the facilities. Under the alternative method provided for in the standard, the undistributed assets are allocated to the G&A expense pool. The alternative method may be used only if the contracting parties agree that depreciation/amortization generated by the undistributed assets is immaterial or the results obtained from this alternative procedure are comparable to those which would have been obtained under the regular method.

(3) In determining the average net book values for facilities employed by the business unit, auditors will be required to examine asset records to the extent necessary in the circumstances.

(a) Initially, the auditor's review should establish the validity of the average values used by the contractor. The standard provides that, where there has been a major fluctuation in the level of facilities during the cost accounting period, the simple average of the beginning and ending net book values may not be appropriate. Where significant variations have occurred, the auditor should recommend a procedure for calculating the average that more accurately reflects the actual experience.

(b) The facilities capital values used as a basis for the cost of money must, in general, be the same values used to generate allowable depreciation or amortization cost (ASBCA Case No. 32419, Raytheon Co.). Land which is integral to the regular operation of the business unit will be included. Operating leases which are treated as constructive ownership will be included at net book value on the CASB-CMF form starting with beginning of the lease term. Where leasing costs have previously been accepted as less costly to the government under the lease period, renewal of the lease requires a

new comparison of lease/ownership costs. If this comparison results in the allowance of constructive ownership costs in lieu of rental costs, the lease will be included at net book value on the CASB-CMF starting with the beginning of the lease renewal. The net book value will be based on fair value at asset acquisition (date that lease was entered into or renewed if appropriate) less the amount, if any, which would have been depreciated had the asset been purchased. The net book value assigned to the leased asset will not include the cost of money. Leasehold improvements may be considered in computing the cost of money if they are subject to amortization. Goodwill is not to be included in the cost of money computation. The acquisition value for all contractor-owned tangible assets and those leased assets for which constructive cost of ownership is allowed in lieu of rental costs should be determined in accordance with CAS 404. Depreciation charges applicable to assets included in the cost of money computation will be determined in accordance with CAS 409.

(c) To be included in the base for the cost of money computation, the asset must be used in regular business activity. Where a contractor maintains depreciation records for groups of assets, the auditor should review the assets in the group to see if they should be included in the cost of money computation. In addition, the auditors should carefully review contractor land purchases and leases to determine if they are an integral part of the regular operation of the business. The auditor should request the contractor to demonstrate that land purchases and leases in question were acquired as a reasonable response to a prudent forecast of the contractor's regular business activity and therefore are integral to the regular operations of the business. If the purchase/lease costs do not meet this requirement then the auditor should assure that these costs are properly excluded from the CAS 414 computation. The following would not be considered as being used in the regular business activity.

1. Land held for speculation.

18-414.1c.

2. Facilities or capacity which have been determined to be idle in accordance with FAR 31.205-17.

3. Assets which are under construction for a contractor's own use (see CAM 8-417.2a.).

4. Assets which have been constructed or purchased but have not yet been placed into service.

(4) The cost of money rate to be used in computing the cost of money factors is determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97. This rate is published semiannually in the Federal Register. The rate published in December is applicable to the period from 1 January through 30 June; the rate published in June is applicable to the period from 1 July through 31 December. Rates in effect since 1 January 1982 are as follows:

	January - June	July - December
1982	14.75%	15.5%
1983	11.25%	11.5%
1984	12.375%	14.375%
1985	12.125%	10.375%
1986	9.75%	8.5%
1987	7.625%	8.875%
1988	9.375%	9.25%
1989	9.75%	9.125%
1990	8.5%	9.0%
1991	8.375%	8.5%
1992	6.875%	7.0%
1993	6.5%	5.625%
1994	5.5%	7.0%

(5) In calculating final facilities capital cost of money factors, the cost of money rate is the average of the treasury rates. For example, the cost of money rate for the fiscal year ending 31 October 1987 would be computed as follows:

Period	Treasury Rate	Proration	Cost of Money Rate
1986 2nd Half	8½%	2/12	1.417%
1987 1st Half	7½%	6/12	3.813%
1987 2nd Half	8½%	4/12	2.958%
			<u>8.188%</u>

The contractor must compute and support the cost of money factors. Based on

the auditor's recommendation, the ACO determines whether the factors are valid for contract cost and pricing purposes.

d. The CASB-CMF form will be used to support the cost of money factors used in incurred cost allocations and forward pricing proposals. In developing the factors used in forward pricing proposals, the contractor should take into account the latest available cost of money rate and a forecast of the facilities net book values and allocation bases for each cost accounting period of contract performance. In some instances, where projected asset value and allocation bases are not expected to vary significantly from the latest completed cost accounting period, the same facilities values and allocation bases as are required for retroactive cost determination may be used for forward pricing purposes.

(1) In as much as significant changes in any of the variables, i.e., net book value of facilities, the treasury rate or the allocation base may change the relationship and affect the cost of money factor, the auditor should closely review any proposed cost of money calculation before it is accepted as a basis for negotiation. The latest available semiannual interest rate should be verified and known or anticipated additions/deletions of assets, as well as the effect of the annual depreciation on the net book value, should be examined. The allocation bases used in the cost of money computation should be compared for consistency with those used in estimating indirect cost rates.

(2) When the average cost of money rate to be used in costing the contract is known, this average rate should be used in lieu of the latest semiannual treasury rate. This situation could occur when a short-term contract is negotiated and performed within the 6-month period after all the rates to be weighted in the actual historical cost of money are known. As an example, a contractor on a calendar year basis receives a contract on 1 July 1987, with a performance period of 1 July 1987 to 31 December 1987. The treasury rate for 1 July 1987 to 31 December 1987 was published in June 1987. Since the contract will be costed after-the-fact using the arithmetic aver-

age of the two semiannual rates for 1987, $7.625\% + 8.875\%/2 = 8.25\%$, the 8.25 percent rate should also be used for pricing the contract. Auditors should be aware that the interest rate which will be in effect during the negotiation and applied to the contractor's estimate may not be known when the audit report is written. If this is the case, we should qualify the audit report regarding the allocable cost of money. The qualification should advise that if a new rate is available, the PCO should consider recomputing the cost of money amount before finalizing negotiations.

e. FAR 31.205-18 governs the composition, allocation, and allowability of IR&D and B&P costs. FAR 31.205-18 states that "Both direct and indirect costs shall be determined on the same basis as if the IR&D (or B&P) project were under contract." Therefore, the cost of money is allocable to IR&D and B&P projects. However, it should be accounted for separately and not included in IR&D/B&P costs for the purpose of determining whether the established ceiling has been exceeded. The cost of money allocable to unallowable IR&D and B&P costs (that is, that portion which exceeds the established ceiling) shall be considered unallowable.

f. The CASB regulations do not expressly require the disclosure of the practices used by the contractor to determine and assign the cost of money. However, since the cost of money calculation is considered to be a significant accounting matter, an adequate description of the practices involved would facilitate the acquisition process. Accordingly, auditors should formally advise ACOs in audit reports that contractors should be required to revise their Disclosure Statements to include a description of their cost of money procedures. This disclosure will include the procedures for identifying assets, calculating net book values, assigning net book values to indirect cost pools, and reallocating undistributed net book values to indirect cost pools. This Disclosure Statement revision may be a single statement to the effect that the contractor will use the same procedures used in identifying and allocating depreciation to final cost objectives and that

land will be assigned in the same manner as the facilities to which it relates. A more detailed statement describing the procedures relating to the assets assigned to each indirect expense pool should be required when the CAS 414 procedures vary from those used to measure, assign, and allocate depreciation. The contractor should also disclose whether (1) the regular method will be used, (2) the alternate method will be used, and (3) if the cost of money will be included in the G&A allocation base. The CAS Working Group Interim Guidance Paper No. 77-18 contains an example of an acceptable Disclosure Statement description of procedures used to compute cost of money. Once an option as to the inclusion of cost of money in the G&A allocation base is selected, a change from one to the other should be considered a voluntary change.

g. Contractors will include the amount proposed for cost of money in the appropriate section of the SF 1411 supported by Form CASB-CMF and any other detail required to comply with 10 U.S.C. 2306a, Truth in Negotiations. Where the contractor elects to exclude the cost of money from its proposal or claim for reimbursement, such costs should be designated as unallowable and may not be included in profit. In addition, the contractor is still required to compute the cost of money factors in accordance with CAS 414. The failure to make the computation is considered a violation of a major requirement of the standard. In virtually all cases, however, the noncompliance will not result in increased cost paid by the government. We should therefore issue noncompliance reports only if the acquisition office or the ACO requests them. If no such request is made, we will advise the ACO by memorandum of the technical noncompliance. We will also include appropriate comments in the proposal audit report as well.

h. Request for audits of the contractor's computation of the cost of money may be received in connection with individual price proposals, forward pricing rate agreements, and the establishment of final indirect cost rates. With each of these audits, the report to the ACO will state whether the contractor has com-

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plied with the standard and the requirements of the acquisition regulations.

i. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

**8-415 Cost Accounting Standard 415
— Accounting for the Cost of
Deferred Compensation**

a. The purpose of this standard is to provide criteria for measuring deferred compensation costs and assigning those costs to cost accounting periods. It applies to all deferred compensation costs except for compensated absences and pension costs covered in CAS 408 and CAS 412.

b. The standard was effective 10 July 1977. It must be applied to all new deferred compensation awards made in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable. It does not disturb the contractual provisions applicable to prior awards. It allows the deferred compensation cost awarded before the applicability date to be allocated as a cost when paid under existing contracts.

c. FAR 31.205-6(k) makes CAS 415 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed deferred compensation costs, where significant, are in compliance with the provisions of CAS 415.

8-415.1 General

a. Deferred compensation is an award made by an employer to compensate an employee in a future cost accounting period for services rendered prior to receipt of compensation. It does not include normal year-end salary, wage, or bonus accruals.

b. Deferred compensation costs are measured by the present value of future benefits to be paid and are assigned to the cost accounting period in which the contractor becomes obligated to compensate the employee. The contractor incurs this obligation when:

(1) The requirement for future payment cannot be unilaterally avoided by the contractor.

(2) The award is to be paid in money, other assets, or shares of the contractor's stock.

(3) The future payment can be measured reasonably accurately.

(4) The recipient of the award is known.

(5) Events entitling an employee to receive an award have a reasonable probability of occurrence.

(6) There is reasonable probability that stock options will be exercised. These conditions are basically those recognized under generally accepted accounting principles for establishing a liability. Where these conditions are not met, the deferred compensation cost will be assigned to the period of payment.

c. If the award is based on employee's performance of future service to receive benefits, the contractor's obligation is established as the future service is performed.

d. The treasury rate determined by the Secretary of the Treasury pursuant to Public Law 92-41, 85 Statute 97, effective when the cost is assigned, will be used for computing the present value of future benefits. The treasury rate considers current private commercial interest rates for loans maturing in approximately five years and is considered the most appropriate rate for discounting deferred compensation costs.

e. The measurement and assignment of present values of future benefits to cost accounting periods should be separate for each award. However, the cost estimated on a group basis for employees covered by a deferred compensation plan will be acceptable if the cost can be measured with reasonable accuracy and includes an adjustment for probable forfeitures.

f. The auditor's review should:

(1) Identify all deferred compensation awards currently provided to employees.

(2) Determine what accounting changes, if any, are contemplated as a result of the standard. (According to FAR 52.230-5, the contractor is required to describe to the ACO the kind of changes required by the standard.) If the contractor previously utilized a cash basis of

accounting for deferred compensation costs on government contracts, a change from a cash to an accrual basis will be required for all new awards made after the applicability date of the standard.

(3) Verify, through examination of the award provisions, that all applicable conditions for establishing the obligation for compensation have been met for those awards in which the entire cost is recognized in the year of award.

(4) Review the present-value calculations to determine that the treasury rate specified in the standard has been used correctly.

(5) Review costs for proper credit of estimated forfeitures, based on past experience and future expectations, where deferred compensation costs are accounted for on a group basis.

g. Interest cost will be included in computing future benefits for all deferred compensation cash awards which provide for the payment of interest. The allowability of such interest cost will be determined in accordance with applicable acquisition regulations. If the award stipulates a fixed interest rate, the interest cost is assigned at the fixed rate to the cost accounting period in which the contractor is obligated to compensate the employee. Some deferred compensation awards provide for the payment of interest at variable rates from the date of the award until payment. When the variable rate is based on specified index which is determinable by cost accounting period, the interest cost is assigned to the applicable period at the actual rate for the index at the close of the period. Since that rate may vary from the actual rates in future periods, adjustments will be made in any future period in which the variable rate materially affects the cost of deferred compensation. When the variable rate is not based on a specified index and is not determinable by year, the total interest cost will be assigned to the period of payment. The auditor should review each deferred compensation plan which provides for a cash award, to determine whether the payment of interest is required. For each plan which provides for interest, the auditor should check the contractor's annual interest cost calculation to ascertain that only interest costs

for which the rates are fixed or based on specific indices have been accrued.

h. If a deferred compensation plan for a cash award requires irrevocable funding (including interest) of future payments to employees, the amount irrevocably funded will be assigned to the cost accounting period in which the funding occurs.

i. The deferred compensation cost of an award of contractor stock will be based on the current or prevailing market value of the stock (as indicated by market quotations) on the date the number of shares awarded becomes known. It should be noted that the standard does not provide for present value discounting of the market price for stock. Since the market price is presumed to reflect future expectations, further discounting would not be appropriate.

j. The cost of an award of an asset other than cash, will be based on the market value of the asset when the award is made. If the market value is not available, a fair value of the asset will be established. The auditor should verify that the claimed market value of the asset is supported by a valid appraisal obtained from an outside source.

k. If the terms of an award of either cash, other assets, or stock require that an employee perform future service to receive benefits, the deferred compensation cost will be assigned on a pro rata basis to those applicable periods of current and future service. The standard does not specify the method or proration but provides that the proration be based on the circumstances of the award. The requirement of the standard conforms with Accounting Principles Board Opinion No. 12 which states that only the portion applicable to the current period should be accrued if elements of both current and future services are present. The auditor should determine the basis on which the contractor prorates costs between current and future periods. Where deferred compensation plans do not clearly establish a basis for prorating costs between accounting periods, the contractor will be required to support the prorations. In most instances the contractor, because of the ease of computation, will prorate the costs evenly over the number of years of additional service required before exer-

cise of the award. For example, a contractor, declaring a year-end cash award to key employees under a plan requiring three additional years of service before payment, prorates the cost evenly over the following three years (excluding adjustment for present value factors). The contractor's proration would be accepted by the auditor unless the circumstances of the award clearly indicated that the award was related in total, or in part, to past services rendered.

l. Any forfeitures which reduce the contractor's obligation for payment of deferred compensation will be credited to contract costs in the period the forfeiture occurs. The reduction will be the amount of the award assigned to the prior period(s), plus interest compounded annually at the Secretary of the Treasury rate under Public Law 92-41, 85 Statute 97. For irrevocably funded plans, the reduction will be the amount initially funded, adjusted for a pro rata share of fund gains or losses. The voluntary failure of a recipient to exercise a stock option is not considered a forfeiture. If the cost of a cash award for a group deferred compensation plan is later determined to be greater than the amount initially assigned due to an overestimate of forfeitures, the additional cost attributable to the incorrect estimate will be assigned to the cost accounting period in which the revised cost becomes known.

m. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-415.2 Illustrations

The following illustrations are intended to supplement those in paragraph 415.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** The cost of a contractor's deferred compensation plan for a cash award is assigned to the cost accounting period in which the award is made. Under the provisions of the plan, the contractor has complete authority over forfeiture. If an employee is reassigned or laid off before he is eligible for benefits,

the contractor may forfeit the employee's rights to the benefits.

Solution. Under CAS 415.50(a), one criteria for incurring an obligation is that the contractor cannot unilaterally avoid future payment. As a result of the contractor's discretionary control over the forfeiture provisions, this would not be considered a valid obligation. The cost should therefore be assigned to the year paid, not the year awarded.

b. **Problem.** The contractor's deferred compensation requires all cash awards to be increased by an eight percent interest factor.

Solution. The cost of future benefits assigned to the current accounting period should include interest cost calculated at eight percent compounded annually according to CAS 415.50(d)(1).

c. **Problem.** The contractor accounts for the cost of a cash award deferred compensation plan on a group basis, adjusted for an estimated four percent forfeiture allowance. At the close of its fiscal year 1987 the actual cost of forfeitures amounted to only three percent as a result of a lower employee turnover than was originally anticipated.

Solution. The additional cost resulting from the overestimated forfeiture allowance should be charged to deferred compensations costs in fiscal year 1987.

d. **Problem.** The contractor has a deferred compensation plan which specifies that an employee receiving a cash award must remain with the company for three years after the award to receive benefits. On 31 March 1987 (fiscal year-end) the contractor awards \$5,000 to an employee to be paid on 31 March 1990. According to the plan's requirement for irrevocable funding of future payments, the cost payable to the employee on 31 March 1990 was funded on 31 March 1987.

Solution. The entire amount irrevocably funded must be assigned to the fiscal year ending 31 March 1987 according to CAS 415.50(d)(6).

e. **Problem.** The circumstances are the same as for problem d. above except the employee voluntarily terminates his employment on 30 May 1987. On the date of termination the fund has appreciated eight percent.

Solution. The amount irrevocably funded plus eight percent for the fund gain will be credited to deferred compensation costs in fiscal year-end 31 March 1988 as a forfeiture reduction.

f. Problem. The contractor maintains a self-insured retiree death benefit plan for which costs are recorded at the time the death benefit is paid. Questions have been raised as to whether these benefits should be considered deferred compensation subject to CAS 415 and whether the liability for currently retired employees should be accrued.

Solution. These benefits are not deferred compensation as contemplated in CAS 415. CAS 415.50(a)(3) requires a reasonably accurate measurement of future payments as a condition for accrual. Retiree death benefits could only be accrued by introducing mortality assumptions and this was not considered to fall within the meaning of "reasonable accuracy" as used in the standard.

8-416 Cost Accounting Standard 416 — Accounting for Insurance Costs

CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and their allocation to cost objectives. The standard was effective 10 July 1979 and is applicable to a contractor on or after the start of its next accounting period beginning after the receipt of a CAS-covered contract.

8-416.1 General

a. CAS 416 covers accounting for purchased insurance, self-insurance, and payments to a trustee of an insurance fund. When coverage is obtained through purchase of insurance or payment into an insurance fund, the premium or payment normally should represent the insurance cost. Amounts representing coverage for more than one year should be assigned pro rata among the cost accounting periods covered by the policy term. When coverage is not obtained through purchased insurance or payment into an insurance fund, the contractor should follow a program of self-insurance in accordance with criteria in the standard. Self-insurance is defined as the assumption

or retention of the risk of loss by a contractor, either voluntarily or involuntarily. Absence of insurance is regarded as one form of self-insurance. The contractor should make a self-insurance charge for each period for each type of self-insured risk based on an estimate of the projected average loss for that period. Insurance administration expenses which are material in relation to total insurance costs should be allocated on the same basis as the related costs.

b. FAR 31.205-19 makes the self insurance provisions of CAS 416 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed insurance costs, where significant, are in compliance with the provisions of CAS 416.

8-416.2 Guidance

a. The standard requires the contractor to maintain records to substantiate the amounts of premiums, refunds, dividends, losses, and self-insurance charges. Records should also show the frequency, amount, and location of actual losses by major type of risk.

b. A contractor may need memorandum records to reflect material differences between insurance costs determined in accordance with CAS 416 and those includable in financial statements prepared in accordance with Financial Accounting Standards Board (FASB) Statement 5, Accounting for Contingencies. FASB Statement 5 does not permit an accrual for loss contingencies in a contractor's financial accounting records unless (1) an asset has been impaired or a liability incurred at the date of financial statements and (2) the amount can be reasonably estimated. Insurance costs determined in accordance with CAS 416 cannot be accrued in financial accounting records unless they represent purchased insurance, actual payment to a trustee, or the recognition of an actual loss. A self-insurance charge which only represents exposure to the risk of loss cannot be accrued.

c. Exposure to the risk of loss may differ significantly between defense and commercial operations and products. When risks differ significantly, defense

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and commercial insurance costs should be accumulated and allocated separately.

d. The audit of insurance premiums and payments to trustees should include:

(1) Examining insurance policies to determine the basis for establishing and adjusting premiums, and any provision for deposits and reserves.

(2) Determining whether the contractor controls or has a financial interest in the insurer. Purchase of insurance from a related organization may be a form of self-insurance which should be audited in accordance with 8-416.2e.

(3) Examining the transactions in connection with an insurance reserve or fund in order to establish compliance with CAS 416.50(a)(iv) and (v).

(4) Reviewing direct allocations of premium costs to final cost objectives to detect possible noncompliance with CAS 402.

(5) Reviewing the assignment of premiums, refunds, and assessments to and among cost accounting periods.

e. CAS 416 does not establish minimum financial requirements for a contractor's self-insurance program. In order to assure that a contractor has adequate financial resources for a self-insurance program, FAR 31.205-19 requires contracting officer approval of a self-insurance program before the related costs are allowable. Auditors may be requested to furnish data in connection with the evaluation of the proposed self-insurance program. Self-insurance charges should be audited for compliance with CAS 416 and the approved program. The audit of self-insurance charges should include:

(1) Reviewing the contractor's overall self-insurance program and the adequacy of supporting records.

(2) Analyzing the nature, amount and pattern of actual insurance losses.

(3) Evaluating the contractor's method of estimating projected average loss from actual loss data.

(4) Comparing the self-insurance charge with the cost of purchased insurance when it is available.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-416.3 Illustrations

The following illustrations are intended to supplement those in paragraph 416.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

a. **Problem.** Contractor X establishes an approved self-insurance program to cover employee group health plans beginning with its next accounting period. The contractor makes a self-insurance charge based on analysis of its actual loss experience over the prior 10-year period and an evaluation of anticipated conditions. The auditor determines that a well-known insurance company offers coverage at a cost materially lower than the self-insurance charge. The contractor refuses to purchase insurance because the insurance company is a subsidiary of a competitor and has a poor reputation.

Solution. The contractor's practice complies with CAS 416 even though purchased insurance is available at a lesser cost. Paragraph 5 of the supplemental information published with CAS 416 states that the limitation in CAS 416.50(a)(2)(i) is intended to apply only when the cost of comparable purchased insurance is used as a convenient method of estimating the projected average loss. The contractor's action is still subject to the test of reasonableness contained in FAR 31.201-3, and the difference between the cost of self-insurance and purchased insurance should be questioned if there is sufficient evidence that the contractor's reasons are not valid.

b. **Problem.** Contractor Y proposes to discontinue its purchased insurance coverage and become self-insured without setting aside specific financial resources to cover future losses.

Solution. If the self-insurance charge is measured and allocated properly following the criteria in CAS 416.50(a)(2), the proposed practice complies with the standard regardless of the availability of specific financial resources to cover future losses. The same cost, however, may be unallowable under provisions of FAR 31.205-19 if the self-insurance program has not been approved by the ACO.

**8-417 Cost Accounting Standard 417
— Cost of Money as an Element of
the Cost of Capital Assets Under
Construction**

a. This standard establishes criteria for the measurement of the cost of money attributable to capital assets under construction, fabrication, or development as an element of the cost of those assets. The standard was effective 15 December 1980. It is applicable on or after the start of the next fiscal year beginning after receipt of a contract to which the standard applies.

b. FAR 31.205-10 makes CAS 417 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money costs, where significant, are in compliance with the provisions of CAS 417.

8-417.1 General

a. The standard's fundamental requirement provides that the cost of money applicable to the investment in tangible and intangible capital assets being constructed, fabricated, or developed for a contractor's own use, shall be included in the capitalized acquisition cost of such assets.

b. For each capital asset being constructed, fabricated, or developed, a representative investment amount shall be determined each cost accounting period, giving appropriate consideration to the rate at which costs of construction are incurred. The cost of money applicable to each asset shall be calculated using the applicable interest rates determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters).

c. Cost of money shall not be capitalized for any period during which substantially all the activities necessary to get the asset ready for its intended use are discontinued unless such discontinuance arises out of causes beyond the control and without the fault or negligence of the contractor.

8-417.2 Guidance

a. CAS 417 applies to both tangible and intangible assets being constructed, fabricated, or developed for a contractor's own use. Cost of money applicable to land should be added to the basis of the land rather than to the depreciable portion of the asset under construction. Land should not be included in the representative cost until the start of activity necessary to get it ready for its intended use, such as foundation development, landscaping, etc.

b. Cost of money should be computed only once for each cost accounting period that the asset is under construction based on the representative investment during the cost accounting period. Amounts capitalized as cost of money in one cost accounting period should be included in the representative investment for succeeding periods. Cost of money shall be calculated using the time-weighted interest rates determined by the Secretary of the Treasury. It is not necessary to enter the cost of money on the accounting records; however, the contractor should make a memorandum entry of the cost and maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry.

c. The representative investment is the calculated amount considered invested by the contractor in the project to construct, fabricate, or develop the asset during the cost accounting period. In calculating the representative investment, consideration must be given to the rate of expenditure pattern of this investment. For example, if most of the investment was at the end of the cost accounting period, the representative investment calculation must reflect this fact. DFARS Subpart 230.71 provides guidance in computing representative investment where a contractor experiences an uneven or irregular expenditure pattern.

d. The standard requires that if substantially all activity necessary to get the asset ready for its intended use is discontinued, cost of money shall not be capitalized for the period of discontinuance. However, when such discontinuance occurs beyond the control and without the

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fault or negligence of the contractor, the cost of money will continue to be capitalized. Therefore, the construction-in-progress accounts should be scrutinized to see if activity has ceased or dropped to a nominal amount. If this occurs, the circumstances should be examined. Brief interruptions and delays because of technical construction problems, labor disputes, inclement weather, shortage of material, etc. will not require discontinuance of capitalization of cost of money.

e. Assets purchased but not immediately put into service because they require installation are permitted to be included in the base for determining cost of money during the period of installation. However, caution should be taken to ensure that the activities necessary to get the asset ready for its intended use are not discontinued.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-417.3 Illustrations

The following illustration is intended to supplement those in paragraph 417.60 of the standard. It is to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

Problem. A contractor purchases a turbine for \$1 million on 1 January 1986. The installation requires six months and is completed on 3 June 1986. The contractor capitalizes cost of money during the six-month period of installation stating that it was the CASB's intent that contractor investment be recognized through cost of money.

Solution. The contractor is entitled to capitalize cost of money during the six-month installation period. However, in the event that the activities necessary to get the asset ready for its intended use are discontinued, cost of money will not be capitalized for the period of discontinuance.

8-418 Cost Accounting Standard 418 — Allocation of Direct and Indirect Costs

CAS 418 requires the consistent classification of costs as direct or indirect,

establishes criteria for accumulating indirect costs in indirect cost pools, and provides guidance on allocating indirect cost pools. The standard was effective 20 September 1980. It is applicable on or after the start of the second fiscal year beginning after receipt of a contract to which the standard applies.

8-418.1 General

The standard's fundamental requirements provide that (1) a business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied; (2) indirect costs shall be accumulated in indirect cost pools which are homogeneous; and (3) pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationships of the pooled costs to cost objectives. While the CAS and the FAR are similar with regard to the conceptual basis, the standard goes beyond the requirements of the FAR and provides more definitive guidance for allocation base selection.

8-418.2 Guidance

a. The requirement for a written statement of accounting policies for classifying costs as direct or indirect is a critical aspect for assuring consistent implementation of this standard. If information disclosed by the contractor in "Part III, Direct vs. Indirect," Item 3.1.0, of the Disclosure Statement is insufficient to meet this requirement, the contractor should be requested to furnish additional detail.

b. Materiality is emphasized in evaluating any perceived need for change in cost accounting practices. Materiality criteria are in 48 CFR 9903.305.

c. When a noncompliance condition is not reported because the amounts are not material, periodic reviews are required to ascertain that the amounts remain immaterial. Noncompliant conditions that currently involve immaterial amounts but which may involve material amounts in the future should be reported to the ACO in accordance with 8-302.7.

d. The creation of additional indirect cost pools should be required only if

changes will result in materially different cost allocations.

e. Homogeneity of indirect cost pools is a significant requirement of the standard; however, a pool may be considered homogeneous if the separate allocation of costs of the dissimilar activities would not result in a materially different allocation of cost to cost objectives. Where there are no audit problems with the existing structure, it is not anticipated that CAS 418 would require further review of the homogeneity of indirect cost pools. However, the allocation base for those pools must still be reviewed for compliance with the standard.

f. Where current problems regarding the allocation of direct and/or indirect costs do exist, CAS 418 provides authoritative support and criteria which may be helpful in formulating an acceptable solution.

g. Where the contractor is establishing new indirect cost pools, careful attention should be directed toward whether the pools meet the requirements of the standard. Audit considerations, applicable to conditions both before and after the establishment of a new pool, should include propriety of the allocation base, homogeneity of the cost pools, and materiality.

h. For purposes of selecting an allocation base, CAS 418 distinguishes between two types of indirect cost pools: (1) those which include a material amount of the costs of management and supervision of activities involving direct labor or direct material, and (2) those which do not.

(1) If an indirect cost pool contains a material amount of the costs of management or supervision of activities involving direct labor or direct material, the standard requires selecting an allocation base representative of the activity being supervised. Allocation bases are limited to direct labor hours or dollars, machine hours, units of production, or material costs, whichever is more likely to vary in proportion to the costs included in the cost pool being allocated.

(2) If an indirect cost pool does not contain material amounts of the costs of management or supervision of activities involving direct labor or direct material, the standard specifies criteria for select-

ing a base representing an appropriate measure of resource consumption. The standard establishes a hierarchy of acceptable representations of beneficial or causal relationships between the activities in the pool and benefiting cost objectives. The best representation is a measure of the resource consumption of the activities of the indirect cost pool. If consumption measures are unavailable, or impractical to ascertain, the next best representation is a measure of the output of the activities of the indirect cost pool. If neither resources consumed nor output of the activities can be measured practically, the standard requires the use of a surrogate that varies in proportion to the services received to be used as a measure of resources consumed.

i. The allocation base used should result in an allocation to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives. Where the allocation base used is direct labor hours or dollars, all work accomplished, including hours worked in excess of 8 hours per day/40 hours per week by exempt employees or assigned costs, should be included as appropriate in the base for allocation of overhead costs. (See 6-410.3d.)

j. The criteria in CAS 407 should be applied to the use of average and preestablished direct labor rates. Material variances must be allocated annually to cost objectives in proportion to costs previously allocated.

k. Contractors are required to review preestablished rates for indirect costing at least annually, and revise the rates to reflect anticipated conditions. In addition, variances between actual or anticipated rates and preestablished rates must be disposed of at least annually, if material.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-418.3 Illustrations

The following illustrations are intended to supplement those in paragraph 418.60 of the standard. They are to be used as a guide in determining whether a

contractor's practices comply with the standard's provisions.

a. **Problem.** Contractor A proposes to establish an allocation method for the central reproduction cost center. The contractor wants to use the number of personnel in each department as the base for allocation of the cost center.

Solution. A central reproduction cost center does not contain a material amount of management and supervision of activities involving direct labor and direct material. Hence, the selection of a base is governed by CAS 418.50(e). Number of personnel is a surrogate for resource consumption which may be representative of the beneficial or causal relationship between the cost center and the benefiting cost objectives. However, acceptability of this base requires an analysis of the availability of more preferred bases:

(1) The best measure of resource consumption related to a central reproduction cost center may be equipment usage (hours). However, if the reproduction equipment does not have time meters and installation is not cost-effective, the use of such a base would be impractical.

(2) The next best representation of beneficial or causal relationship is output. A base consisting of the number of reproduced pages might be selected as an appropriate allocation measure of the output of the activities of the central reproduction cost center. However, if it is not practical to measure the number of pages reproduced for each requesting activity, a surrogate that varies in proportion to the services rendered may be used to measure the resources consumed.

(3) Such a surrogate could be the number of personnel in each department if past experience demonstrates that the number of requisitions varies in reasonable proportion to departmental population, thereby constituting a reasonable measure of the activity of the cost objectives receiving the service. Accordingly, the method adopted by the contractor could constitute an acceptable allocation basis, depending upon the circumstances.

b. **Problem.** An audit of contractor B reveals that several indirect cost pools contain costs of activities having dissimilar beneficial or causal relationships to

cost objectives to which the pool is allocated. Further analysis indicates that allocation of the costs of the activities, included in the cost pool, result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

Solution. The contractor's practice is currently in compliance with CAS 418.50(b)(1). However, if it is expected that the practice will have a material impact in the future and the probability of this impact can be specifically commented upon, the situation should be reported to the cognizant ACO. In addition, periodic followup reviews should be performed to ascertain whether circumstances have changed the allocation differences from immaterial to material.

c. **Problem.** The base for allocation of overhead costs at contractor C is direct labor hours. Although contractor C's salaried employees work on the average 60 hours a week, only 8 hours per day and 40 hours per week are recorded on the employees' timesheets. Floor checks and employee interviews have revealed that the excess hours worked by salaried employees are, in many cases, incurred on cost type contracts in an overrun situation, bid and proposal costs in excess of the negotiated ceiling, and other fixed price and commercial work.

Solution. Subject to the criteria of materiality, the contractor should be cited as being in noncompliance with CAS 418.50(d) in that the base selected to measure the allocation of the pooled costs to cost objectives is not a base representative of the activity being managed or supervised and all significant elements of the selected base have not been included. The contractor should be required to record excess hours worked by salaried employees and include all direct labor hours worked in the base for allocation of overhead costs. (See 6-410.)

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8-420 Cost Accounting Standard 420 — Accounting for Independent Research and Development Costs and Bid and Proposal Costs (IR&D/B&P)

a. This standard provides criteria for the accumulation of IR&D/B&P costs

and for the allocation of such costs to cost objectives. The standard was effective 15 March 1980 and must be followed as of the start of the second fiscal year beginning after the receipt of a CAS-covered contract. It does not apply to contractors subject to Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments.

b. FAR 31.205-18 makes CAS 420 partially applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed IR&D/B&P costs, where significant, are in compliance with the provisions of CAS 420.

8-420.1 General

The standard provides that IR&D/B&P costs are to be accumulated by project. Under specific conditions, costs of IR&D/B&P projects performed by a segment but benefiting more than one segment must be accumulated at the home office. Home office IR&D/B&P costs are to be allocated to segments through (1) allocation to specific segment(s) when beneficial or causal identification can be made, or (2) use of the CAS 403 residual expense allocation base. Special allocations are also permitted. IR&D/B&P costs accumulated at segments (including home office allocations and transfers from other segments) will be allocated to final cost objectives using the same base used for G&A expenses under CAS 410; however, special allocations are permitted.

8-420.2 Guidance

a. The requirements for accumulation of IR&D/B&P costs by project and home office accumulation of IR&D/B&P projects benefiting more than one segment increase the need for maintaining close coordination between the CAC, CHOA, or GAC and auditors at operating segments. It is necessary that project identification be retained on costs transferred from a segment to a home office in order that appropriate allocations from the home office to all benefiting segments can be accomplished. The coordination process includes reviews of advance

agreement proposals and audits of incurred costs.

b. The standard provides that IR&D/B&P costs accumulated at the home office which can be identified with one or more specific segments shall be allocated to the specific segment(s). The standard does not specify the allocation method to be used when two or more (but not all) segments of an organization benefit from a specific IR&D/B&P project. In evaluating the method used, consideration must be given to whether the base will reasonably match cost distributions with the beneficial or casual relationships between the IR&D/B&P projects and the segments. The most straightforward base would consist of the same components used to allocate home office residual expenses. However, among other potentially acceptable bases are total cost input and production labor hours or dollars. This listing is not all inclusive and any base which reasonably matches cost with the beneficial or causal relationships between IR&D and B&P projects and benefiting segments would be acceptable under the provision of the standard.

c. The standard's prefatory comments indicate that a definition for B&P administrative costs was proposed by commentators, i.e., "B&P administrative costs, when not separately identified and classified as B&P costs in accordance with the contractor's normal accounting practice, are not considered B&P costs for the purpose of this standard." The CASB concluded that the proposed definition was not necessary because it dealt with allocation requirements which are addressed in CAS 420.50(a)(1). CAS 420.50(a)(1) states that IR&D/B&P project costs shall include "... costs, which if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective" B&P administrative costs, when not separately identified, may be excluded from the B&P pool if in accordance with the contractor's normal accounting practice. B&P administrative costs which are charged to an overhead (non-B&P) pool are not construed as being incurred "in like circumstances for a final cost objective." Therefore, the standard does not disturb the accounting

treatment of B&P administrative costs under the FAR provisions.

d. Special allocations of IR&D/B&P costs are permitted from the home office to specific segments and from segment cost pools to specific final cost objectives provided the particular segment or final cost objective would receive a disproportionate allocation of the costs by using the prescribed allocation base. However, the special allocation must be commensurate with the benefits received. The provisions governing special allocations (CAS 420.50(e)(2) and 420.50(f)(2)) are applicable to occurrences which are exceptions to the contractor's normal operation, and are not intended for application to segment groups or classes of contracts or final costs objectives. As is the case with special allocations under CAS 403.40(c)(3) and 410.50(j), it appears the CASB's intent is to use the special allocation provisions to resolve specific situations where equitable allocation cannot be achieved by normal methods. When a special allocation under CAS 420.50(e)(2) or 420.50(f)(2) is used, it must be described in the contractor's disclosure statement. The description should identify the specific special allocation and the circumstances which require it.

e. The standard provides that any work performed by one segment for another segment shall not be treated as IR&D or B&P costs of the performing segment unless the work is part of an IR&D or B&P project of the performing segment (CAS 420.50(d)). If the work of the performing segment does not qualify as IR&D or B&P effort, the costs, including business unit G&A expenses, are transferred directly to the receiving segment. Auditors at the performing segment will have the primary responsibility for reviewing the propriety of the accounting treatment of these interdivisional costs.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-420.3 Illustrations

The following illustrations are intended to supplement those in paragraph 420.60 of the standard. They are to be

used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** A contractor currently uses a total cost input allocation base for G&A. In implementing CAS 420, this contractor proposes to exclude purchased services and major subcontracts from the allocation base for IR&D/B&P costs, citing the special allocation provisions of CAS 420.50(f)(2). The contractor points out that this practice - i.e., the exclusion of these costs from allocation of IR&D/B&P, has been accepted in previous years.

Solution. This practice would not be in compliance with the standard. Allocation of IR&D/B&P costs to final cost objectives is to be on the same allocation base used for G&A. Special allocations for classes of contracts (e.g., exclusions of major subcontracts from the base) are not appropriate under CAS 420.50(f)(2). The special allocation provision in CAS 420.50(f)(2) is limited to circumstances of a particular final cost objective.

b. **Problem.** Contractor H charges an engineering department's typing services for proposal preparation direct to B&P projects. General support typing services applicable to B&P and other departmental effort are not separately identified but are charged to an intermediate overhead pool and allocated to B&P projects, contract engineering projects, and other cost objectives based on labor hours.

Solution. The contractor's practice of charging general support B&P typing services to an intermediate overhead pool is in compliance with CAS 420.50(a)(i). The B&P general support typing effort is not separately identified and classified as B&P cost and is not construed as being incurred "in like circumstances for a final cost objective." Therefore, B&P general support typing effort is allocable to an overhead account, providing the allocation practice is otherwise considered acceptable and equitable.

c. **Problem.** Company R has eight segments. Segment A performs IR&D projects which have technical application to it and two other segments. Technical application is not identifiable to the remaining five segments. The cost of

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¶8-420.3c.

those projects performed by Segment A is transferred to the home office and allocated in equal parts (one-third) to the three segments.

Solution. Company R is in compliance with CAS 420.50(e)(1) and 420.50(f)(1) providing the technical applications received by the three segments are equal. If

an allocation of equal shares does not reflect the participation in technical applications, other allocation bases that could be considered include total cost input (for the three segments) or a base consisting of the same components used to allocate home office residual expenses.

8-500 Section 5 — Review of Cost Impact Proposals Submitted Pursuant to the Cost Accounting Standards Clause

8-501 Introduction

This section contains guidance on the review of contractor cost impact proposals which are submitted in accordance with the price adjustment provisions of the CAS clause.

8-502 General

8-502.1 CAS Clause Requiring Price Adjustments

Under paragraph (a)(5) of the CAS clause (FAR 52.230-2), contractors and subcontractors are required to agree to contract price adjustments, with interest, if increased costs to the government result from their failure to comply with CAS or to follow their disclosed cost accounting practices in estimating, accumulating and reporting costs on contracts containing the CAS clause. The CAS clause specifically provides in paragraph (a)(4)(i) for an equitable price adjustment when a new standard causes a change in the contractor's cost accounting practices; paragraph (a)(4)(iii) for an equitable price adjustment when the parties agree to a change to either a disclosed or established cost accounting practice; and paragraph (a)(4)(ii) that adjustments resulting from all other changes may not result in any net increased costs to the government.

8-502.2 FAR Requirement for Submission of Cost Impact Proposal

a. Whenever a contractor makes a change to disclosed or established accounting practices or is determined to be in noncompliance, FAR 52.230-5 requires the submission of a cost impact proposal within 60 days (or other mutually agreed-upon date) after the proposed change is determined adequate and compliant.

b. An integral part of the cost impact proposal is the list of CAS-covered contracts and subcontracts which will be affected by the change or noncompliance. To comply with the requirements of FAR 52.230-5, contractors should maintain a

system for identifying accurately and completely all contracts and subcontracts containing the CAS clause. The auditor should review the adequacy of contractors' procedures and report to the ACO if the contractor does not maintain the required records. Once the contractor has established such procedures, perform limited test checks of contract listings on specific cost impact proposals to assure the continuing effectiveness of the contractor's system. Report exceptions in the cost impact proposal evaluation report. For smaller contractors, test the listing of CAS-covered contracts included in specific cost impact proposals against FAO files of active cost reimbursable contracts and listings of CAS-covered fixed price procurement actions available within DoD. (See CAS Working Group Paper 77-17.)

8-502.3 Cost Impact Proposal Data Requirements

A basic problem encountered by auditors is the proper preparation of a proposal by the contractor. FAR requires the proposal be prepared in the manner and form (level of detail) agreed to by the contracting officer (usually with audit advice). Any cost impact proposal format specified by the ACO should allow the same approximate result as if the cost impact for each CAS-covered contract was calculated individually. The basic required data include (i) identification of each CAS-covered contract and cost impact (including cost, profit/fee, and price/amount) on each CAS-covered contract and subcontract or, if agreed to by the ACO, a representative selection of contracts which will give the same approximate result as if the cost impact on each CAS-covered contract was calculated individually and (ii) grouping the CAS-covered contracts and subcontracts by contract type (e.g., FFP, FPI, CPFF, CPIF) and by the various Departments/agencies (e.g., Army, Navy, Air Force, NASA, DoE). If inadequately prepared, return the proposal to the contrac-

tor through the ACO with deficiencies specifically identified.

8-502.4 Review of Proposed Price Changes

Under FAR 30.602-1(e)/DFARS 230.601(a)(4) the auditor is responsible for reviewing proposed price changes submitted by contractors or subcontractors as a result of revisions made to previously disclosed or established cost accounting practices. The purpose of the review is to ascertain whether the proposed amounts are fair and reasonable. Audit advice should be provided considering materiality and risk criteria. Auditors should consider an array of audit procedures as appropriate during review of cost impact proposals, including statistical and judgment sampling, risk assessment, past experience, discussion with contractor personnel, and comparison with previous cost estimates. The results of these reviews will be reported to the ACO responsible for negotiating the price adjustment.

8-502.5 Requirement for Cost Impact Proposal

Cost Impact proposals are required in the following instances:

a. The contractor or subcontractor is required to comply prospectively with a new cost accounting standard. The related cost impact proposal provides a basis for an equitable adjustment on CAS-covered contracts existing on the effective date of the standard in accordance with FAR 52.230-2(a)(4)(i) and may result in either price increases or decreases.

b. The contracting officer proposes a change in the disclosed or established accounting practices or the contractor proposes such a change and the contracting officer agrees. Such changes include early implementation of new cost accounting standards. (See 8-301c.) The related cost impact proposal provides a basis for an equitable adjustment on CAS-covered contracts in accordance with FAR 52.230-2(a)(4)(iii) and may result in either increases or decreases. Other changes are subject to the provisions of FAR 52.230-2(a)(4)(ii) and shall not increase the net cost paid by the government on covered contracts. Only

prospective adjustments will be made for these changes. (See CAS Working Group Paper 79-23.)

c. The contractor fails to comply with an applicable cost accounting standard or to consistently follow any disclosed or established cost accounting practice. FAR 52.230-2(a)(5) requires that when increased costs as defined in FAR 30.306 result, contract prices or cost allowances must be adjusted. Such adjustment shall provide for recovery of the increased costs to the government together with interest thereon computed using the Secretary of the Treasury, Public Law 92-41, interest rate from the time the payment by the government was made to the time the adjustment is effected. The recently passed Public Law 100-679 states that the interest rate applicable to any contract price adjustment shall be the annual rate of interest established under section 6621 of the Internal Revenue Code of 1986 (U.S.C. 6621). However, Public Law 100-679 requires that the effective date for use of the new interest rate be set by the new Cost Accounting Standards Board through an amendment to the FAR. Until such an amendment has been published, the government will continue to use the interest rate pursuant to Public Law 92-41, 85 Stat. 97 to determine interest on contract price adjustments.

8-502.6 Inclusion of Implementation Costs

Implementation costs may be included in cost impact statements only to the extent they are a part of appropriate indirect expense pools and allocated in accordance with the contractor's normal accounting practices. (See CAS Working Group Paper 76-5.)

8-502.7 Noncompliance with FAR Part 31

The FAR 52.230-2 CAS clause does not provide for price adjustment for noncompliance with FAR Part 31. Therefore, if a contractor fails to follow FAR, cost disapprovals will be processed in accordance with existing procedures. However, if the contractor is required to change an accounting practice because of failure to follow FAR (for example, a change to a distribution base previously

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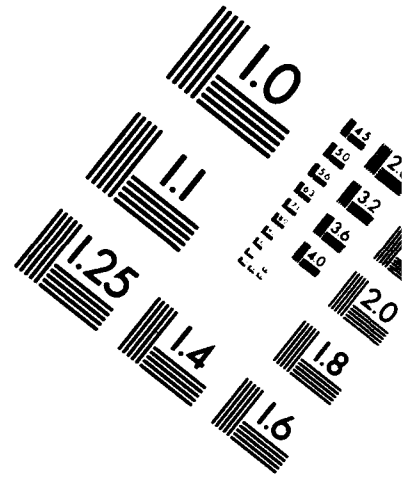
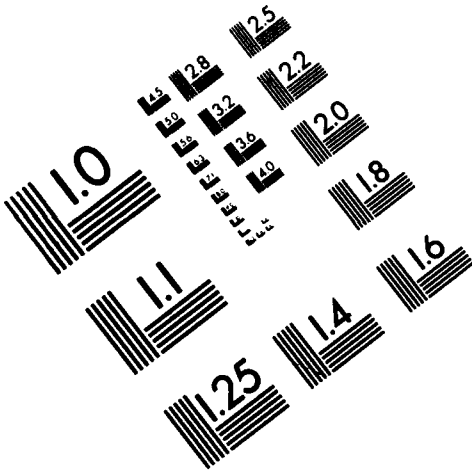


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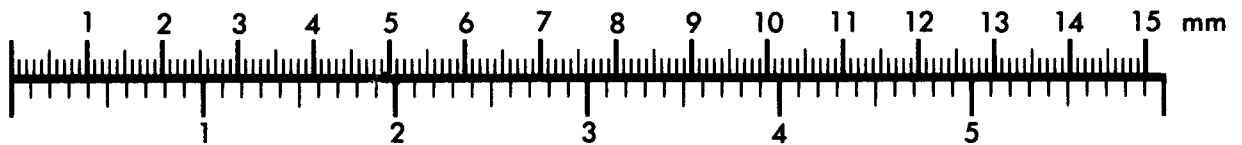
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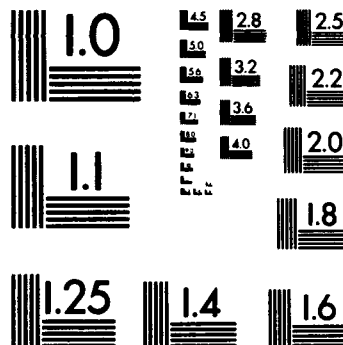
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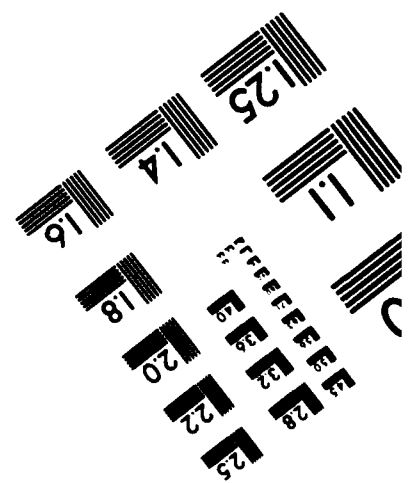
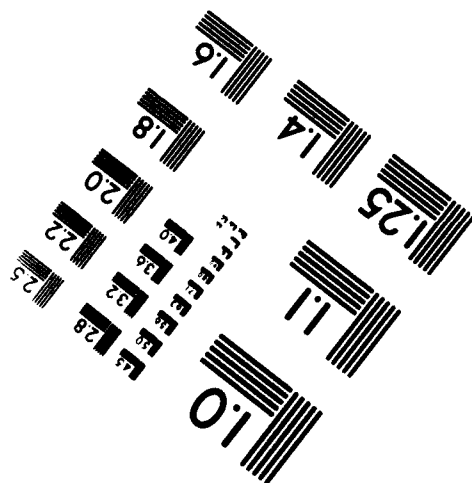
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used for pricing and/or recording purposes), then prospective adjustments to all CAS-covered contracts would be required under 8-502.5, above. (See 8-302.7.)

8-503 Guidance**8-503.1 Types of Reviews**

In evaluating cost impact proposals, the auditor will perform essentially two types of reviews:

a. An evaluation of the contractor's estimate of the cost impact on covered contracts caused by changes in cost accounting practices. (The resulting adjustments to covered contracts are applied only on a prospective basis.)

b. A review of proposed cost increases to the government caused by the contractor's failure to follow consistently its disclosed or established practices or to comply with applicable cost accounting standards. The amount of the adjustment is the increase in cost to the government over what the cost would have been had the contractor complied with the standards and/or followed consistently its disclosed or established practices.

8-503.2 Increased Costs — Changes

Increased costs to the government under FFP contracts should be considered to exist when the costs allocated to the contracts are less than would have been allocated if the method of allocation had not been changed. This concept, which is specifically cited in 48 CFR 9903.306 related to noncompliances, should apply to all price adjustments involving FFP contracts. (See CAS Working Group Papers 76-4 and 76-9.)

8-503.3 Increased Costs — Noncompliance

For noncompliance on firm fixed price contracts, the amount of "increased costs" to the government is the difference between cost estimates used in negotiations and lower cost estimates that would have been used had the contractor complied with the applicable CASB rules, regulations, and standards. This measurement is necessary since "increased costs" on FFP contracts cannot be mea-

sured in terms of higher costs to be reimbursed during contract performance. Consequently, if the contractor failed to accumulate costs in consonance with its disclosed or established practices and applicable standards, the appropriate adjustment for the noncompliance will be computed as described. For noncompliances on flexibly priced contracts, the "increased cost" to the government is the difference between the current estimated cost at completion under the noncompliant method and the same estimate reconstructed under the compliant method. (See CAS Working Group Papers 76-4 and 76-9.)

8-503.4 Cost Adjustments for Changes

Cost adjustments for either mandatory or voluntary changes should generally be the net difference between the current estimated cost to complete under the old accounting method and the same estimate reconstructed to reflect the new method. (See CAS Working Group Paper 76-9.)

8-503.5 Cost Offset Techniques

The proposed cost effect and the related audit recommendations must be shown on a contract-by-contract basis to enable the ACO to identify the affected contracts and determine the amount of the adjustment for each contract involved. Adherence to this format (contract-by-contract) by the contractor and the auditor is particularly vital when cost offsets apply. No specific method for offsetting price increases and decreases has been prescribed. It is the ACO's responsibility to address each specific situation in a way that best accomplishes the overall objective and to assure that the offset technique is applied judiciously so that the final cost to the government or to individual departments or agencies is not materially different from that which would have resulted if the contract prices had actually been adjusted. Offsets affecting incentive contracts should be carefully reviewed to avoid material impacts on the incentive provisions. The following guidelines should be employed in using offset techniques (see CAS Working Group Paper 76-8):

a. Contracts may be adjusted individually or cost increases and decreases may be offset to reduce the number of contract adjustments for mandatory and voluntary changes and for noncompliances.

b. Cost increases at one organizational segment of a company may be offset by decreases at another segment if the change causes costs to flow between the segments either directly or via a higher organizational level such as a home office.

c. Within a segment, the effect of several changes may be combined in the offset consideration if the changes all take place at the same time.

d. When a mix of contract types is involved, grouping of contracts by type, by materiality of cost impact, or other type segregation may often reduce the complexity of the problem and also reduce the number of price adjustments that must be made.

8-503.6 Adequacy of Cost Impact Proposals

Pursuant to acquisition regulations that implement the CASB promulgations, contractors and subcontractors are required to submit proposals that reflect the cost impact of changes made to their disclosed or established cost accounting practices. The auditor should initially review such cost impact proposals for adequacy of content and method of presentation. If inadequately prepared, return the proposal to the contractor through the ACO with the deficiencies specifically identified.

8-503.7 Failure to Submit Cost Impact Proposal

a. Auditors should work closely with the administrative contracting officer (ACO) to get contractors to submit timely and adequate cost impact proposals. It may be necessary for the ACO to instruct the contractor that the withhold provisions of FAR 30.602-1(f) will be implemented if an adequate cost impact proposal is not submitted by a stipulated date.

b. If the contractor fails to submit a cost impact proposal, FAR provides that the ACO, with the assistance of the

auditor, shall estimate the cost impact on contracts and subcontracts containing the CAS clause. Base the estimate, as much as possible, on readily available data. The auditor's objective is not to relieve the contractor of its responsibility for preparing the cost impact statement but merely to provide sufficient information upon which the ACO can base a unilateral decision. Once the ACO's final decision has been rendered, the burden of proof should rest with the contractor to demonstrate, through a detailed analysis, the cost impact on each CAS-covered contract and subcontract, rather than to debate the merits of the government estimate. (This is similar to the procedure established in FAR 49.109-7 for termination settlement by unilateral determination.) The associated audit report should include (1) the scope of the review, (2) a description of the circumstances relating to the contractor's failure to submit a cost impact proposal, and (3) the basis used to develop the estimate. If the auditor is unable to provide the estimate, the report should give the reasons and identify the data needed to comply with the ACO's request.

c. Although not specifically provided for in the FAR, auditors may also be requested by the ACO to provide an estimate of the cost impact prior to the ACO's exercising of the FAR withhold provisions. The FAR withhold provisions provide that the ACO may withhold an amount not to exceed 10 percent of each subsequent payment request related to the contractor's CAS covered prime contracts which contain the appropriate withholding provisions until the cost impact proposal has been furnished. In these situations, the estimate of the cost impact will be used by the ACO to determine a maximum amount that should be withheld. Again, the estimate of the cost impact should be based, as much as possible, on readily available data. Also recommend to the ACO that withholding begin immediately and continue while the estimate of the cost impact is being developed.

8-504 Conferences and Reports on Cost Impact Proposal Reviews

a. See 4-300 for guidance on entrance, interim, and exit conferences with the

contractor. When appropriate, e.g., when there are numerous CAS-covered contracts, a series of changes, or complicated changes, the contractor and the government should discuss and agree in advance on the manner and form of a cost impact proposal in order to ease the administrative process.

b. Promptly after completing each cost impact proposal review, prepare and distribute a report using the guidance in 10-808.

8-505 Coordination

Extensive coordination will be required when the adjustments are for changes to or failure to follow home

office accounting practices. Such adjustments will affect all contracts at all organizational units which receive cost allocations from the home office. It is expected, therefore, that the CAC, the CHOA, the GAC, and/or the auditor cognizant of an intermediate management organization will furnish the auditors cognizant of all segments with the results of the review on distributing home office expenses so that the proposed effect on contracts at the receiving segments can be verified. The cognizant auditors would then report back to the CAC, CHOA, or GAC who would issue a consolidated report to the ACO responsible for the home office.

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CHAPTER 9**9-000 REVIEW OF COST ESTIMATES AND PRICE PROPOSALS****9-001 Scope of Chapter**

a. This chapter presents guidance for evaluating estimates of cost and profit supporting price proposals submitted by contractors in connection with the award, administration, modification, or repricing of government contracts. The guidance applies to audit of estimates submitted in connection with negotiation of the following: (1) prices of firm-fixed-price contracts; (2) initial and adjusted prices of redeterminable fixed-price contracts; (3) initial and successive target costs of incentive fixed-price and incentive cost-reimbursement contracts; (4) estimated costs of cost-plus-fixed-fee contracts; (5) prices of spare parts; (6) contract change proposals; (7) rates for time and material and technical services contracts; (8) claims for price adjustments due to abnormal events; (9) economic price adjustments; (10) price adjustments pursuant to Cost Accounting Standards clauses; and (11) advance agreements on forward pricing factors such as indirect cost rates, labor hour rates, material handling rates, and other elements of pricing formulas to be used repetitively.

b. Section 1 discusses administrative procedures for field pricing support; that section includes coverage of requests to provide specific cost information and to assist higher-tier contractors review proposals submitted by subcontractors. Section 2 provides guidance in evaluating the adequacy of cost or pricing data in the proposal. Section 3 discusses general evaluation procedures for estimates. Sections 4 through 7 present specific guidelines for evaluating cost estimates for direct labor, direct material, other direct costs, and indirect costs. Section 8 presents special considerations in pricing the impact of inflation, including the review of proposed contractual economic price adjustment provisions. Profit evaluation assistance to the contracting officer is discussed in Section 9. Section 10 highlights audit criteria for review of estimates derived from cost estimating

relationships that involve noncost variables. Section 11 presents procedures applicable to comprehensive team surveys of contractors' estimating systems by auditors and technical specialists. Section 12 provides guidance in evaluating forward pricing rate agreements. Section 13 provides guidance for DCAA participation as a member of a should-cost review team.

9-002 Related Audit Guidance

a. Audit report preparation is covered in Chapter 10. Since audit reporting requirements affect the field work required, be familiar with Chapter 10 provisions applicable to the proposal at hand before you begin the proposal review.

b. Appendix E and Appendix F, which describe graphic and computational analysis and improvement curve analysis techniques as evaluation tools, should be used in conjunction with this chapter.

c. Throughout this chapter, various Cost Accounting Standards are cited. Refer to the complete text of CASB Rules, Regulations and Standards and to Chapter 8 for audit guidance on CAS.

d. When appropriate, the Agency DIIS application software should be used to expedite (1) rate applications; (2) audit summarization; and (3) preparation of summary working papers, audit report exhibits, and rate schedules.

e. As part of planning the review of a price proposal, brief the request for proposals in accordance with 3-203. During each review of cost estimates or price proposals, observe any operations security (OPSEC) measures required by current DoD contracts or requests for proposals, in accordance with 3-205.

9-003 The Total Audit Environment

a. The guidance in this chapter should be applied to the audit of individual proposals with due regard for the audit environment, considering previous audit experience with the contractor and the

materiality of the various elements of the proposal. A detailed evaluation of each element of every proposal submitted for review is normally unnecessary.

b. Make full use of all relevant knowledge about the contractor which has been documented in prior reviews. This would include:

(1) The strengths or weaknesses of the contractor's estimating system, which may also be the subject of a separate review (5-1200).

(2) The general credibility of the contractor's proposals, as determined in the course of previous proposal evaluations and postaward audits. (When a contractor's accounting practices or representations of historical and projected costs repeatedly contain significant deficiencies, errors, or unreasonable estimates which suggest either negligence or an

apparent intent to deceive the government, such cases are reportable under 4-700.)

(3) The reliability of the contractor's cost accounting system.

(4) Current trends in the contractor's labor, indirect cost, or other costs, as reflected in the results of recent proposal evaluations or audits of incurred costs.

(5) Current changes in and/or modernization of the contractor's manufacturing practices as noted during tours of the manufacturing floor, perambulations, and in the results of estimating surveys, recent proposal evaluations, or audits of incurred costs. (Changing the flow of how products are made can affect the flow of costs (14-800)).

(6) Cost avoidance recommendations made as a result of operations audits and other functional reviews (14-500).

9-100 Section 1 — Administrative Procedures for Field Pricing Support**9-101 Introduction**

a. This section presents the general procedures for processing requests for advisory audit reports and other contract audit information related to contractor and subcontractor price proposals. Basic guidance on audit field work and preparation of audit reports is not repeated in this section (see subsequent sections of this chapter and 10-300).

b. The term "PCO" is also applied to a plant representative/ACO who has been delegated procurement authority to execute the particular contract action.

9-102 The Field Pricing Support Concept**9-102.1 The Approach**

a. FAR 15.8 and DFARS 215.8 describe the responsibilities and functions in the review, analysis, and negotiation of price proposals, and related matters concerning negotiated procurements. Much of this guidance applies to all types of negotiated pricing actions, including contract price redetermination after costs have been incurred under the contract. However, certain requirements may apply only to the initial pricing of contracts, contract additions, or contract modifications (sometimes called forward or preaward pricing actions).

b. Field pricing support consists of all audit and other specialist effort necessary for the contracting officer to determine the reasonableness of the proposed cost or price. FAR 15.805-5 assigns the contracting officer responsibility for determining the extent of field pricing support required, and for establishing the specific areas in which audit input is needed. This usually results in a price proposal audit request to perform a complete examination of the contractor's price proposal. However, the contracting officer may occasionally request an audit of only specific cost elements within a proposal (e.g., review only proposed material costs); or request only the application of agreed-upon procedures (e.g., verify current labor rates or apply certain attest

procedures to high-value material items). (See 9-107 for adiscussion of requests for specific cost information and 9-108 for requests to review part of a proposal.) A clear understanding of the requester's needs is essential for establishing the audit scope as discussed in 9-103.3. When significant contractor deficiencies or system problems exist, the auditor should explain them to the contracting officer and discuss the potential for additional audit coverage. When a request is received for an audit of the entire proposal and there is little risk involved, discuss with the requester if their needs could be met by other services such as reviewing part of the proposal (9-108) or providing specific cost information (9-107). There are special requirements for reporting on an audit of a part of a contractor's proposal as stated in 9-108, 9-206, 9-207, and 10-300.

c. Under the DoD approach (DFARS 215.805-5), the plant representative/ACO is the team manager for all PCO requests for field pricing support. The PCO sends all such requests to the plant representative/ACO, with a copy to the cognizant contract audit office; the contract auditor shall treat the advance copy of the PCO request as a signal to begin the audit work. If after receiving an advance request there is concern about whether an audit will be necessary, immediately discuss the matter with the ACO. Any uncertainty about whether an audit will be needed should be resolved in favor of starting the audit. If the ACO states that an audit will not be requested, contact the PCO to determine whether ACO actions will be sufficient. If the PCO states that an audit is necessary, it should be performed as a direct request in accordance with FAR 15.805-5(c) and the ACO should be so advised (see 9-103.1(d)(7)).

d. DFARS 215.805-5(a)(2)(A) outlines the procedural steps for coordinating field pricing support. This evaluation process is conducted as a cooperative team effort in order to ensure timely and effective response to the PCO's request. The efforts of all field pricing support

team members are complementary, therefore, cooperation and communication are essential in order to establish a proper understanding of each members' role.

e. The procedural steps involving contract audit are discussed in later paragraphs of this section. The roles and relationships described in 9-305 also apply in the field pricing support situation.

9-102.2 Applicability of Procurement Procedures

FAR/DFARS procedures are cited in this section for convenience and only briefly outlined. Slight variations may occur among DoD components, and procedures applicable to non-DoD agencies may differ. Auditors reviewing major or numerous proposals for a particular DoD or non-DoD contracting activity should be familiar with the applicable agency FAR supplement and any special proposal requirements of the procurement office. This information is needed to ensure good support to the PCO, to anticipate procurement needs for contract audit services, and to estimate and monitor workload trends. It is especially important in this regard to know the procurement office's dollar thresholds and related criteria for requesting field review of proposals (9-102.3).

9-102.3 Applicability of Dollar Thresholds

a. DFARS 215.805-5(a)(1)(A) requires contracting officers to request field pricing support for contract and modification proposals in excess of \$500,000 for fixed-price contracts and \$1,000,000 for cost-type contracts. The requirement may be waived, with adequate written justification, by the contracting officer. Generally, field pricing support should not be requested for proposals below these thresholds. However, if the contracting officer becomes aware that the cognizant administrative contracting officer has found a significant deficiency in the contractor's estimating system and has instructed the contractor to correct the deficiency, field pricing reports shall be requested for fixed-priced proposals in excess of \$250,000 and cost-type proposals in excess of \$500,000.

b. FAR 15.805-5(b) permits contracting officers to request an audit of a proposal below the thresholds when there are unusual circumstances. These include (1) lack of knowledge of the contractor, (2) sensitive conditions, or (3) inability to evaluate the price reasonableness. When requested to audit a proposal that is below the threshold, the auditor should understand the unusual circumstances (see. 9-103.1d(3)).

9-103 DCAA Field Pricing Support at the Prime Contract Level

9-103.1 Coordinating the PCO Request for an Audit

a. In responding to requests for audit services, FAO managers, supervisors, and auditors should keep in mind that the contracting officer is our customer. Our aim is to provide timely and responsive audits, audit reports and financial advisory services that meet our customer's needs. This goal can be achieved by establishing open and effective channels of communication which allow for the sharing of information and ideas as the audit progresses.

b. In particular, requests for field pricing support need to be handled in an expeditious manner. Proposals should be reviewed for adequacy criteria within seven days after receiving the proposal so that corrective action can be taken immediately. In addition, expeditious handling of this matter will enable the auditor to meet the requestor's time constraints. The auditor should seek assistance from the ACO/PCO, if needed, early in this process. The Agency has also developed criteria which can be used to evaluate the adequacy of contract pricing proposals. The auditor may discuss the checklist with contracting officers and suggest that they use it in the screening process. The form is available on the FAO DIIS subsystem (file name ADEQUACY).

c. Locally established working arrangements may expedite handling of relatively routine requests. However, effective field pricing support to the PCO may, in some cases, require individualized cooperative arrangements between the plant representative/ACO and the auditor.

Also, some matters may need reconsideration during the course of major field pricing support cases.

d. Additional key matters the auditor needs to coordinate with the plant representative/ACO are listed below (see FAR 15.805-5(c)(1)).

(1) Obtaining a copy of the contractor's proposal and applicable portions of the RFP, if not received with the PCO request.

(2) Establishing the due date for the audit report, considering existing audit workload, required audit scope, or any other relevant factors. The contract auditor should coordinate due date adjustments with the plant representative/ACO and the PCO. Any audit conflicts involving more than one PCO should be worked out jointly between the auditor and the plant representative/ACO (see 9-103.7).

(3) Obtaining a clear understanding of the requester's needs and identifying areas of the contractor's proposal for special consideration (in addition to any specified by the PCO). If the request is for an audit of something that is immaterial or that could be handled as a request for specific cost information (see 9-107.1), the auditor should discuss this with and make an appropriate recommendation to the contracting officer. However, the final decision regarding the need for a complete audit rests with the contracting officer.

(4) Arranging for all technical input needed for the audit, including field technical reports the PCO requests to be incorporated into the audit report. Technical input can often be obtained through informal consultation, however, written confirmation of the requested information should follow. Similarly, informal audit input may be needed to support other field pricing support efforts before the audit report is prepared (see 9-306 and D-204).

(5) Arranging for any needed supplementary analysis of subcontract or intracompany proposals by the prime contractor and/or government field personnel. Time constraints require that this area be given early, expedited attention (see 9-104 and 9-105).

(6) Obtaining the PCO's estimate of most likely level of procurement requirements under a proposed basic ordering agreement or time-and-materials-type contract. The reasonableness of proposed costs should be evaluated considering the anticipated level of effort.

(7) In some cases, requests will be received directly from the PCO. Auditors should not delay these reviews awaiting a request through the ACO. When these requests are received, necessary coordination will be made directly with the requester. In addition, auditors should advise the plant representative/ACO of the request.

9-103.2 Acknowledging the Request

At an early stage in planning the audit, send a memorandum to the plant representative/ACO (or PCO if it relates to a direct request) confirming the following matters:

a. Dates the request for audit and the contractor's proposal were received.

b. The due date for issuing the audit report. (In establishing the time required to complete a satisfactory review, include any areas for special emphasis or specific requirements requested by the PCO or coordinated with the plant representative/ACO.)

c. The areas of the contractor's proposal to be given special consideration.

d. The arrangements for submission of reports on any (1) technical analyses and (2) reviews of subcontract and intracompany proposals.

e. Any other relevant items that would improve the coordination process.

9-103.3 Audit Scope

a. Determining the scope of a price proposal audit (FAR 15.805-5(e)) will, in part, depend on the nature of the audit request for field pricing support. When a complete examination of the contractor's price proposal is requested, the auditor is responsible for determining the scope and depth of audit required to render an informed opinion as to the adequacy of the cost or pricing data for negotiation of a price, including the use of technical specialists when necessary. DCAAF 7640-36 can be used to document the risk assessment and scope determination. Re-

quests to audit part(s) of a price proposal are discussed in 9-108.

b. As early as possible, determine whether technical review requested by the ACO will be sufficient to allow the auditor to express an opinion regarding the quantitative and qualitative aspects of the contractor's proposal. The auditor is responsible for ensuring that adequate evidential matter is examined to render an opinion on the proposed costs. This includes making decisions about what technical assistance is needed, effectively communicating with the technical specialist(s), assessing the impact of technical specialist findings upon the audit opinion, and reporting on the uses of technical specialists or the impact of their nonavailability (see Appendix D and 9-306).

c. When ACO/PCO-imposed time constraints make it impossible to perform an entire proposal audit, coordinate with the ACO/PCO to determine if other services can be performed in the prescribed time frame to assist in the negotiation of the award (e.g., providing specific cost information or reviewing part of a proposal—see 9-107 and 9-108). If no services can be provided in the prescribed time frame, confirm the results of the conversation in writing with the ACO/PCO.

d. If there is a lack of adequate technical input necessary for the expression of an unqualified opinion regarding the quantitative and qualitative aspects of the proposal, the audit report should be qualified accordingly (10-304.2).

e. In some cases, the risk assessment and other audit planning procedures could conclude that a proposal may be evaluated by a desk review rather than a comprehensive examination of all proposed elements. A desk review consists of a comparison of the contractor's proposal with audit data available or readily obtainable at the FAO on such things as the contractor's estimating methods, current cost/price experience, and currently forecasted labor or indirect cost rates. It involves more than merely checking the contractor's arithmetic. The professional application of audit experience and assessment of materiality and risk is required in order to determine if sufficient information is available to the auditor to

justify a desk review. Limited additional information can sometimes be obtained by telephone inquiry to the contractor. The auditor must also carefully consider any necessary adjustments to the audit scope because of changed conditions, such as a forecasted increase in the contractor's volume of business (allocation base) which may result in a reduction of the indirect cost rate.

f. Desk review procedures are an integral part of the audit planning process and may result in a conclusion that sufficient information is available in the files from other audits to form the basis for expression of an opinion on the contractor's cost statement (estimate or incurred). In such cases, care should be taken to assure that the auditor has complied with government auditing standards.

g. Desk reviews, either alone or in conjunction with a limited review of selected proposal areas, may be appropriate for audit of proposals in the lower dollar ranges. Consequently, a desk review will normally be performed when the following criteria are substantially met:

(1) The contractor has been visited by a contract auditor within the past 12 months and audits are reasonably current.

(2) There are no outstanding CAS or accounting/estimating system deficiencies that have a bearing on the proposal. (The audit files must reflect a prior review of the significant elements of the accounting/estimating system.)

(3) No significant change is expected to occur in the contractor's business which will affect cost projections during the proposed period of performance.

(4) The contractor has been able to support its proposed costs on previous submissions by vendor quotations, prior actual costs, or other acceptable evidential matter. Thus, experience shows minimal or no cost exceptions (other than known repetitive-type exceptions) on previous reviews.

(5) The cost elements proposed are consistent with prior practice and consistently applied with no new costing factors.

(6) The contractor and the government have agreed on forward pricing rates, with appropriate DCAA input, for the proposed period of performance or current rate information is available from recent audits.

9-103.4 Sampling Procedures to be Used

a. Requests to evaluate an inordinate number of items and/or dollar amounts should be discouraged. Criteria used by some procuring offices for reviewing line items may be more extensive than DCAA's established statistical sampling guidance and government auditing standards requirements. Although the auditor establishes the scope of audit following established and accepted statistical sampling procedures (see 4-600 and Appendix B), the requester's sampling procedures may be considered, as appropriate.

b. Coordinate the selected line-item sample with the PCO. Additional line items of particular concern to the PCO that were not selected in the initial sample selection should be looked at separately on a case-by-case basis. Coordinating the stratification process and ensuring that random techniques are properly applied will make the sample results more useful to the auditor and the requester.

c. Value Review. A value review involves a subjective assessment of item prices (as compared to an illustrated parts breakdown, picture, drawing, or sketch of the item), including a short written description of labor, material, and engineering characteristics of the item. The purpose of a value review is to determine if the price offered appears to be a fair value. For example, a value review could determine that \$1.50 is a fair price for a switch, toggle, multi-terminal while \$11.50 may not be a fair price; or that \$10.00 is not a fair price for a particular bolt while \$0.25 may be a fair price. Generally, a value review is performed as a procurement function. Therefore, the auditor should ensure that a listing of all items that failed the value review has been provided as part of the audit request. These items, along with an explanation as to what caused their failure, should be considered as audit leads. If the auditor plans to evaluate a failed

value item separately, the requester should be advised so as to avoid duplication.

9-103.5 Request to Report by Line Item

a. Audit requests which require auditors to spend an inordinate amount of time reporting their findings by line item do not usually result in an economical use of audit resources, particularly when the contractor's accounting system does not identify total cost by individual line item.

b. Although some contractors propose engineering and other direct support effort by using estimating or pricing factors for individual line items, their accounting systems usually do not account for direct support cost by individual line item. Furthermore, the use of such techniques cannot be supported by historical cost experience.

c. When there is no direct relationship between factors and individual line item costs, the total amount of direct support effort should be evaluated by government technical personnel to ascertain the reasonableness of the effort proposed. The auditor will recommend labor and indirect cost rates applied to this total effort and results will be reflected in the audit report. The auditor will also comment on any estimating/pricing techniques used to distribute the direct effort to line items and their impact on the proposed cost.

d. Contractors may not record their costs on a line-item basis and it may not always be practical to track audit findings to a line item. When impediments to identification exist, request contracting officer assistance before any additional audit resources are spent to develop audit findings and write a report by line item. In these cases, the contracting officer should solicit the contractor's assistance to aid in the identification of costs by line item. Such assistance is needed in order for the auditor to report questioned costs by line item.

9-103.6 Requests to Report on Comparative Historical Cost Information

a. The requirement to have comparative historical cost information should be placed on the contractor and included as part of the cost proposal.

b. If a request to develop this type information is received, request that the contractor prepare the information, notify the requester of the action taken, perform whatever audit steps are necessary to verify the accuracy of the information, and include the information with the audit report. In the event the information is not received in time for inclusion in the audit report, include appropriate comments necessary to explain the circumstances. This, of course, does not preclude the inclusion of readily available recent historical cost information in audit reports to support the audit findings.

9-103.7 Scheduling Audit Report Issuance

a. Issuance of a report on an audit of a price proposal should not be delayed beyond the agreed-to due date pending the receipt of an assist audit report (9-104) or technical report (Appendix D). Neither should the report be delayed because of the contractor's verbal statement about revising the proposal. However, other developments during the course of the audit may threaten the audit report schedule, such as:

(1) Serious problems with the contractor such as lack of cooperation, insufficient supporting data, or denial of access to records, which may have a major adverse impact on price negotiations (see also 9-205).

(2) Expansion of audit requirements by the PCO.

(3) Major unanticipated problems with the proposal, such as unusual or complex data or significant controversial items of cost.

(4) New, competing priorities in other PCO requests.

b. Promptly discuss these other developments with the plant representative/ACO. His or her early attention may correct the problem and eliminate the need for the auditor to request a due date change or an audit report qualification. FAR 15.805-5(d) and (e) require that the contracting officer be notified in writing, following immediate verbal notification, of circumstances shown in (1) above. The notification should include a description of the deficient or denied data or records

(copies of the deficient data should be provided, if requested by the contracting officer), the need for the evidence, and the unsupported costs resulting from the denial (1-504.3). In addition, the audit report should identify any cost or pricing data submitted that are not accurate, complete, and current and a schedule of any cost representations that are unsupported (See also 10-304.2e and 10-308.2).

c. Supplemental reports may be required upon receipt of assist audit reports (9-104), technical reports (9-103.8), or receipt of additional cost or pricing data. In addition, FAR 15.805-5(h) requires the contracting officer to request that the auditor immediately review significant information disclosed subsequent to submission of a cost proposal. This information may include data related to costs unsupported in the original audit report. The contracting officer will require the offeror to concurrently submit this data to the audit office. Upon receipt of the data and the audit request, the auditor should initiate a timely review of the data and orally report the results to the contracting officer. When considered necessary by the contracting officer or the auditor, a supplemental report may also be issued if the status of negotiations is such that a supplemental report will serve a useful purpose (10-103.3f and 10-304.4).

d. If an extension of the audit report due date is considered necessary, follow the procedures in 9-103.1, 9-103.2, and 10-300, including coordination, written confirmation, and, if applicable, report qualification.

e. Providing verbal results of audit is merely advance information for the requester and is not a substitute for issuing a written audit report by the established due date.

f. Peak workload periods and other unforeseen strains on FAO audit resources do not relieve FAO management from the responsibility for judicious and timely management of proposal audits (CAM 10-103.1). Therefore, every effort should be made to issue proposal audit reports by the original due dates. In any event, it is generally unacceptable to request a due date extension for 60 days

beyond the date of receipt of the request for audit.

9-103.8 Technical Report Impact on Audit Report Schedule

a. DFARS 215.805-5(e)(6) states that if the auditor requests a technical analysis, the auditor normally will incorporate the financial effect of the analysis in the audit report. In view of the number of technical specialties that could be involved, there may be several technical reports to consider (see 9-103.1 and Appendix D). If the auditor requests a technical analysis, the auditor should not expect any other party to consolidate reports on proposal analyses made by the several technical specialists on the field pricing support team.

b. In the absence of adequate requested technical analysis, the audit report will be qualified (10-300). However, if the auditor can obtain sufficient evidence to support an audit opinion on the proposal, including requirements, then a request should not be made and the report should not be qualified. This holds even if the auditor knows that an evaluation is being done, and the results are not received. A qualification should not be used in this case even though the technical report may question elements which the auditor did not question.

c. Technical report results which are not received in time for inclusion in the initial audit report will be incorporated in a supplemental report, if the status of negotiation is such that a supplemental report will serve a useful purpose. All technical report results received by the auditor will be included in the audit report.

d. Any continued delays in receipt of field technical reports required to satisfy the PCO's request for field pricing support should be treated as a matter of special management concern because of the impact on contract audit workload. If the matter cannot be resolved at the local level, it should be elevated to the regional office.

9-104 Subcontract Proposals Included in Prime Contract Proposals

9-104.1 Basic Responsibilities for Subcontract Proposals

a. FAR 15.804-6(b)(2) requires that SF 1411 support provide data showing the

basis for establishing the source and reasonableness of price. For competitive acquisitions this data should also include the degree of competition. This data should be provided for all acquisitions exceeding the pertinent threshold set forth in FAR 15.804-2(a)(1). For non-competitive acquisitions that meet the requirements of FAR 15.806-2(a) the results of the analysis of the prospective source's proposal as required by FAR 15.806 should also be submitted.

b. Contractors and higher-tier subcontractors are primarily responsible for reviewing their subcontractors. FAR 15.806 requires contractors and higher-tier subcontractors to conduct a cost analysis of each subcontract when cost or pricing data are required by FAR 15.804-6(b)(2) regarding noncompetitive methods and to provide the results of such evaluations prior to negotiations. However, FAR 15.806-3 permits the contracting officer to request audit or field pricing support to analyze and evaluate the proposal of a subcontractor at any tier, if the contracting officer believes that this support is necessary to ensure reasonableness of the total proposed price. DFARS 215.806-3(a)(i) further provides that, if in the opinion of the PCO, plant representative/ACO, or auditor, the review of a prime contractor's proposal requires further government review of subcontractor cost estimates at the subcontractor's plant, these reviews should be fully coordinated with the requester before being initiated.

c. During coordination of the PCO request for audit of a prime contract proposal (9-103.1), the needed coverage of any significant proposed subcontract costs will be a major consideration. The auditor at the prime contract level plays a major role in ensuring that proposed subcontract costs are adequately evaluated. Depending upon the contractor's basis for the proposed subcontract costs, an evaluation may be made only at the prime contractor plant or an audit at the subcontractor plant may be required (see 9-103 and 9-104.2).

d. The prime contract auditor is responsible for providing the subcontract auditor with government price negotiation memorandums applicable to negoti-

9-104.1d.

ations with the prime contractor concerning subcontract prices.

9-104.2 Deciding Whether a Government Field Review of a Subcontractor's Proposal Should be Obtained

a. Generally the prospective prime contractor should support proposed subcontract prices, including performance of cost and price analysis of subcontractor cost or pricing data, when required by FAR 15.804-6(b)(2) regarding noncompetitive methods. DFARS 215.806-1(a)(1) provides that the plant representative/ACO will return inadequate contractor analysis packages for reaccomplishment. The government may decide, however, that adequate review of a prime contract proposal requires field pricing support at the location of one or more prospective subcontractors at any tier.

b. The prime contract auditor will specifically review each pricing submission and available supporting data to advise the contracting officer of the need for subcontractor assist audits. As part of this review, ascertain the adequacy of the prime contractor's completed cost analysis of subcontract proposals. For those cost analyses that are not completed, determine the contractor's completion schedule and consider the adequacy of its procedures for conducting cost analysis. Generally, there will be no need to request an assist audit when the contractor's procedures are adequate and the cost analyses are scheduled for completion prior to negotiation. However, this should always be brought to the attention of the contracting officer (see 9-104.2d). This review and the resulting determinations on the assist audits to be performed will be clearly documented in the audit working papers. The following items will generally indicate a need for an assist audit:

(1) The contractor's cost analysis is inadequate or is not expected to be completed prior to negotiations.

(2) The prime contractor's policies and procedures for awarding subcontracts are inadequate.

(3) There is a business relationship between the prospective prime contractor and subcontractor not conducive to independence and objectivity, as in the case

of a parent-subsidary or when prime and subcontracting roles of the companies are frequently reversed.

(4) The proposed subcontract costs represent a substantial part of the total contract costs.

(5) The prospective prime contractor was denied access to the proposed subcontractor's records.

c. Upon determining and documenting the need for an assist audit, establish whether the assist audit has already been appropriately requested by either the ACO or PCO. If a needed assist audit has not been requested, immediately bring this matter to the attention of the ACO and PCO and convey the reason the assist audit should be obtained. In doing this, provide all available data the contracting officer should consider in making a decision.

d. The auditor should take special care to point out to the ACO and PCO any prime contractor cost analysis that will not be available before the conclusion of audit field work, but is scheduled for completion prior to negotiations (see 9-104.2b). Also comment on the adequacy of the contractor's procedures for conducting cost analysis (see 9-406.1). This information will allow the ACO and/or PCO to decide whether to wait for the contractor's cost analysis or to request an assist audit. When a decision is made to wait for the contractor's cost analysis, the costs should be classified as unsupported (see 10-308.2).

e. When the prime contract auditor determines that the ACO or PCO has requested or will request an assist audit, he or she should at once alert the subcontract auditor by telephone and confirm that the audit can be completed timely (i.e., in time for inclusion in the prime audit report if possible, but in no case later than the due date requested by the ACO or PCO). The prime auditor will immediately confirm the telephone notification via fax or CC:MAIL. If the subcontract auditor has not already begun the audit, it should be started upon such notification.

f. If, after notification and discussion with the ACO and PCO, the assist audit is still determined necessary and it is not going to be requested by either the ACO

or PCO, the prime contract auditor will prepare and address an assist request to the prime contractor ACO. The prime contract auditor will also immediately notify the subcontract auditor by telephone of the impending audit request and send a copy of the request directly to the assist auditor. It should include all of the information required by DCAA's management information system to set up an assist audit assignment including a due date which, if possible, will allow the assist audit results to be incorporated into the prime auditor's report. However, in no case should the requested due date be after prime contract negotiations begin. The request for assist audit should be accompanied by copies of (1) the subcontractor's proposal, along with all related cost, pricing, and pertinent technical data; (2) if available, the results and supporting data from the prime contractor's review of the subcontractor's proposal; and (3) the audit request received by the prime DCAA office (used to identify reimbursable work).

g. A government review of proposed subcontract costs does not relieve the prime contractor of its responsibilities. FAR 15.806-1 requires prime contractors and higher-tier subcontractors to conduct cost analysis of each subcontract proposal for which the subcontractor must submit cost or pricing data. The DCAA auditor should include an appendix in the audit report identifying subcontracts requiring contractor cost analyses which have not yet been provided to the auditor (see 10-307.7).

9-104.3 Advance Notice of Major Program Subcontract Reviews

A DoD contracting activity is required to notify applicable contract administration activities when a planned major acquisition will require extensive, special, or expedited field pricing review of subcontractors' proposals (DFARS 215.806-3(a)(ii)). DCAA support of these programs will be facilitated by prompt and thorough coordination among the PLA, regional offices, FAOs, and Headquarters element involved in the acquisition program.

9-104.4 Processing Requests for Audit of Subcontractor Proposals

a. Under DoD field pricing support procedures, audit requests of subcontractor proposals, at any tier, will be processed through plant representative/ACO channels. This applies whether the request has been initiated by the PCO, by the field pricing support team, or by the cognizant auditor at the prime contractor location. In each case, a copy of the request is to be sent directly to the contract auditor responsible for audit of the prospective subcontractor. The request will be accompanied by copies of (1) the subcontractor's proposal to the prime or higher-tier contractor, including the SF-1411 and related cost or pricing data, and (2) the review package accomplished by the prime contractor and/or by the higher-tier subcontractor involved, including any cost and/or price analysis if available (FAR 15.806-3).

b. Upon receipt of either a copy of the PCO request, a written request through ACO channels, or a copy of the prime contract auditor's request, the auditor at the subcontractor location will set up the assist audit assignment and begin the audit, if not already started as a result of following the guidance for advance telephone notification of impending requests in 9-104.2. Required technical assistance for such audits will be arranged through ACO channels as currently provided for in 9-103.1d.

9-104.5 Special Requirements for Timeliness and Coordination of Subcontractor Audits

a. Time available for proposal audit becomes successively shorter as field pricing support is required at major subcontractors and lower subcontract tiers. To support the PCO on the prime contract pricing action, field audit offices must take special prompt action on requests and reports concerning subcontract proposals.

b. The prime contract auditor is responsible for taking all reasonable steps to ensure that the results of the assist audit are incorporated in the final audit report. This includes following up periodically on the status of all assist audits

9-104.5b.

being performed and documenting this follow-up effort in the audit working papers. Thus, the prime contract auditor must be fully aware of the results of any cost evaluations performed at prospective subcontract locations. Coordinate closely with the plant representative/ACO to ensure complete interchange of communications to and from other plant representatives/ACOs and contract auditors concerning the proposed subcontract costs. If incorporation of assist audit results is not possible, the prime contract auditor should confirm that the assist audit report will be available in time to meet the needs of the ACO/PCO (see 9-104.2e & f).

c. To help ensure timely incorporation of assist audits results into the prime auditor's report, auditors should notify each other by telephone of any impending delays in report issuance.

9-104.6 Differences of Opinion Between DCAA Offices

Should a difference of opinion arise between offices when performing subcontract audits, the procedures stated in 6-806 for resolving the difference will be followed.

9-105 Intracompany Proposals Included in Prime Contract Proposals

a. Basic FAR provisions on responsibilities for subcontract proposals (9-104.1 and 9-104.2) also apply to proposals of other company segments included in a prime contract proposal. However, the factor of common control, or possible lack of arms-length dealing (9-104.2b), make any significant intracompany proposal an area for special consideration in reviewing the prime contract proposal (see 9-103.1).

b. If adequate review of a prime contract proposal requires field pricing support at another segment location, procedures in 9-104 will be followed as applicable to the intracompany situation. This includes processing of requests through plant representative/ACO channels, as well as the special audit coordination requirements stated in 9-104.5.

c. Upon receiving the copy of a request from the higher-tier plant representa-

tive/ACO, the contract auditor at the other segment location will follow procedures in 9-103, 9-104, and 10-300, as applicable to the intracompany situation.

9-106 Reviews of Lower-Tier Proposals Not Included in Prime Contract Proposals**9-106.1 Basic Responsibilities**

a. As covered in 9-104 and 9-105, government field pricing reviews of proposals submitted by prospective or current subcontractors or other company segments are generally made for use of the PCO, as part of the review of a price proposal submitted by a prospective or current prime contractor. This paragraph covers certain cases where DCAA may need to audit a lower-tier price proposal as a separate action, independent of proposal reviews performed for a prime contract pricing action.

b. Each higher-tier contractor is basically responsible for making any needed review of lower-tier proposals, both before and after the prime proposal is negotiated with the government (FAR 15.805-1(c) and 15.806). The same principle applies whether the prime contract pricing action is for a contract award or modification. However, DCAA may be called upon to assist a higher-tier contractor's review when it will serve the government's best interest. Unless a prime contract proposal is immediately under review, this assistance may appear to be for primary use of the higher-tier contractor rather than the PCO. However, as discussed further below, no such review will be made solely to benefit a contractor; there must be a benefit to the government to justify use of government review resources.

c. To satisfy the government auditing standards (2-000) in particular situations, the auditor may also require assist audit of lower-tier price proposals to support other audit objectives, unrelated to audit of a proposal for contract award or modification. This requirement can arise, for example, in connection with:

(1) Audit of incurred costs for acceptability (allowability, allocability, reasonableness, economy and efficiency, and

compliance with other legal and contractual requirements) under an auditable type contract or an unbroken chain of auditable type subcontracts (6-800).

(2) Postaward audit of cost or pricing data (14-100).

(3) Audit of abnormal claims under contracts not otherwise subject to audit (12-000, 12-900, etc.). DCAA procedures in other CAM sections apply to these situations and are not repeated in this section.

9-106.2 Justifying Government Assistance to Higher-Tier Contractor Reviews

a. As a general rule, it would be inefficient and uneconomical for the government to assist an upper-tier contractor before the prime contract proposal has been formally submitted to the PCO. Then, until the prime contract negotiation is completed, any field pricing support effort is for use by the PCO and not for a higher-tier contractor. Reviews for use by a contractor will usually occur only after the prime contract is negotiated.

b. Before concurring in a request for a separate lower-tier proposal review for use by a higher-tier contractor, the contract auditor at the higher-tier should be satisfied that the audit will serve a valid government interest. Generally, this would mean a potential for government prime contract price adjustment if the proposal is found to be misstated. In normal contract situations, therefore, use of government review resources would not be justified where any higher-tier contract or subcontract in the chain actually has a firm-fixed-price (in exceptional cases a firm-fixed-price type contract or subcontract may have a special clause providing for recovery of later subcontract price reductions).

c. DCAA may properly concur in a request for a separate lower-tier proposal review for use by a higher-tier contractor when (1) the expected monetary or non-monetary benefit to the government exceeds the value of requiring the contractor to make the review or (2) review by the contractor is not expected to protect the government interest. Situations which may justify government assistance,

subject to the conditions stated in a. and b. above, can be categorized as follows:

(1) The contractor usually undertakes to review subcontract proposals but has been denied access to the particular subcontractor's records for a valid reason, (e.g., a competitive business relationship).

(2) The contractor has a generally adequate staff for subcontract proposal reviews but has a severe temporary overload of high priority subcontract pricing.

(3) The subcontractor location is distant from the higher-tier contractor and DCAA is in a position to audit the proposal at significantly less cost to the government.

(4) The business relationship between the higher and lower-tier contractors is not conducive to an independent and objective proposal review by the higher-tier contractor, as in the case of procurements between segments of the same company or procurements between companies whose prime and subcontracting roles are frequently reversed.

(5) The government has an unusually large cost risk in the validity of the subcontract price to be negotiated. This situation may arise, for example, if the subcontract is sole source and represents a major portion of the prime contract costs, particularly if the prime contract is also sole source and cost-reimbursable.

9-106.3 Processing Contractors' Requests for Field Pricing Support

Where DoD field pricing support procedures apply, contractor requests for assist audit review of lower-tier proposals will be processed through plant representative/ACO channels. However, the contract auditor at the higher-tier should coordinate closely with the plant representative/ACO concerning the appropriateness of such requests. Audit problems arising from such requests may be referred through DCAA channels for coordination with the higher-tier plant representative/ACO, especially where face-to-face communication may expedite resolution.

9-106.4 Special Considerations — Release of Subcontractor Data to Higher-Tier Contractors

a. FAR 15.806-3(c) governs the methods by which the plant representa-

tive/ACO will release field pricing results to the higher-tier contractor. Where the lower-tier contractor consents, the government will furnish "a summary of the analysis performed in determining any unacceptable costs, by element, included in the subcontract proposal." Absent the lower-tier contractor's consent, the government will furnish "a range of unacceptable costs for each element."

b. Based on the above, a subcontractor's objection to unrestricted release of the audit report may place an extra reporting burden on the higher-tier plant representative/ACO. Therefore, the contract auditor will determine at the start of the review whether the subcontractor will have any restrictions or reservations on release of the report to the higher-tier contractor. If so, promptly notify the requesting plant representative/ACO to determine whether the proposal review should be continued. The plant representative/ACO, working with the higher-tier contractor, may be able to remove the subcontractor's restrictions or reservations.

c. If the review is completed at the request of the plant representative/ACO despite the subcontractor's objections to unrestricted release of the results, audit report marking and contents will be modified per 10-206.3. In no event may the subcontractor withhold its decision on release of the audit report pending review of the audit results or report contents.

d. Where subcontract proposal audits are made on a recurring basis for the same higher-tier contractor, try to expedite the process by developing a working arrangement for unrestricted audit report release. The arrangement should be documented by the subcontractor's representative, with a copy to the plant representative/ACO and the auditor.

9-107 Written and Telephone Requests for Specific Cost Information

9-107.1 Processing Requests for Specific Cost Information

a. In connection with a pricing action, a PCO may request specific information concerning a contractor's costs without

requesting any review of the contractor proposal. Examples of such information include recent costs for specific production items or lots; established pricing formulas such as for spare parts or other logistics items; established prices for standard components; and current rates for labor, indirect costs, per diem, etc.

b. The PCO may request specific cost information by telephone, or in writing, directly from the field auditor. Such requests should receive timely attention. Written requests are sometimes desirable for clarity, but will not be required. See 15-300, and particularly, 15-305.3b, for obtaining the assistance of a DCAA procurement liaison auditor (PLA) in requesting specific cost information.

c. The auditor should ask the requester for the value, type of contract contemplated and the performance period, in order to provide advice on the usefulness of the data being provided. If the information that the requester seeks is considered to be of limited or no use in assessing the reasonableness of the proposed costs, the auditor should explain any concerns to the requester. However, even if the auditor recommends limitations on the use of the information, it must still be furnished.

d. Take care to ensure that contractor data is released only to known authorized government procurement or contract administration personnel. Within 24 hours, by telephone or in person, provide requested information contained in the files or otherwise readily obtainable.

9-107.2 Written Confirmation of Specific Cost Information

a. FAOs (other than PLAs) will issue a written response to each PCO request for specific cost information. Less formal responses should be confirmed within one week. However, specific cost information submitted to the plant representative/ACO at his or her request need not be confirmed in writing unless the requester so desires. See 9-107.3 as to information requested by a higher-tier contractor.

b. The response should be in the form of a memorandum/letter, with "Submission of Specific Cost Information" as the first line of the subject block. Do not use

the terms "report," "audit," or "review," in the subject. State that the purpose is to furnish the cost information requested, and include applicable cautionary statements per 9-107.1c. Whenever applicable, state that the information is based on the contractor's yearly sales volume of \$XXXXXX and may require adjustment if the proposed procurement will affect the contractor's level of operation. Also, when indirect rate information is furnished, state the period to which the rate(s) apply and the cost elements the contractor classifies as the allocation base. Provide a copy of the memorandum to the PLA if any. See Figure 9-1-1 for a sample response format.

9-107.3 Special Considerations — Subcontractor Cost Information

a. Specific cost information on prospective or current subcontractors will be provided to government procurement or contract administration personnel at any tier per the preceding paragraphs. Special care must be taken, however, to ensure that subcontractor information is not released by DCAA to an upper-tier contractor without express permission of the subcontractor. In addition, avoid providing assistance to contractors that would not serve a governmental purpose (see 9-106).

b. The necessity for controlling subcontractor information will usually preclude releasing it to higher-tier contractors by telephone or in person unless the subcontractor's authorized representative is present. Where there are continuing requirements for DCAA confirmation of specific cost information of a subcontractor to a particular higher-tier contractor, a local working arrangement may be made to expedite the process. The arrangement should be documented by the subcontractor's representative, with a copy to the plant representative/ACO and the auditor.

c. If the higher-tier contractor prefers to submit requests for subcontractor specific cost information in writing, this should be accommodated. Coordination between the plant representative/ACO and contract auditor at the requester's plant will establish how such requests are to be processed.

d. The required written response (9-107.2) on subcontractor specific cost information provided to a higher-tier contractor will be addressed to the plant representative/ACO at the higher tier. Distribute a copy to the contract auditor at the higher tier, and distribute a copy to the subcontractor's plant representative/ACO if he or she so desires.

9-108 Review of a Part of a Proposal

a. Auditors will be responsive to a contracting officer request for audit of specified cost element(s) or the application of agreed-upon procedures (such as the verification of rates, the verification of factors, or the review of specific estimating technique(s)) provided it clearly establishes the cost elements to be audited or the agreed-upon procedures to be applied. This applies to contemplated awards made on the basis of negotiation as well as source selection awards made in accordance with FAR Subpart 15.6. In establishing the need for audits of this type, the dollar thresholds by contract type in FAR 15.805-5 and DFARS 215.805-5(a)(1)(A) apply to the total amount of the contractor's proposal regardless of the dollar value of the elements specified for review (also see 9-207).

b. When a full proposal has been prepared, the total price proposal package should accompany these requests even though only certain cost elements will be examined or only specified agreed-upon procedures will be completed (see 9-206). In those situations where the PCO/ACO initially requests an audit of the complete proposal but later modifies this to a review of specified items or the accomplishment of agreed-upon procedures based solely upon the fact that a complete audit cannot be performed within the PCO's requested time frame, the reporting guidance in 10-103.1c is applicable.

c. A clear understanding of the requester's needs is essential. Discussions with the ACO and/or PCO, should be held before beginning the review. When significant contractor deficiencies or system problems exist, explain them and discuss the potential for additional audit cover-

age. Also convey information about prior contract performance and related cost history which the contracting officer may want to consider in finalizing the audit request. However, the final decision regarding the type of review to be performed rests with the contracting officer responsible for negotiating the contract. Once the type of review is established, the auditor should perform the required audit steps and report the findings. The report will confirm the auditor's advice to the contracting officer regarding the potential impact of known contractor deficiencies or systems problems on areas not reviewed and the reasons given by the contracting officer for not expanding the audit request.

d. Audit reports will clearly describe as part of the purpose and scope section what cost elements were reviewed or what agreed-upon procedures were applied. For reports on specified cost elements, the scope section will include the standard paragraph that the review was performed in accordance with GAGAS and an audit opinion on the adequacy and compliance of the cost and pricing data related to the specified cost element reviewed. For reports on agreed upon procedures, the scope section will state that auditing procedures were not performed to constitute an examination made in accordance with GAGAS. A disclaimer of audit opinion will be made unless significant cost and pricing inadequacies or/and FAR and CAS (if applicable) noncompliances are found. In these circumstances, an adverse audit opinion will be reported (see 9-209). Any exhibits included with the report will address only the specified cost element(s) reviewed or the agreed upon procedures applied. However, any known significant estimating system, internal control, or accounting system deficiencies and all known significant FAR or CAS noncompliances will be included in the report. Additional reporting guidance is in 9-200 and 10-300.

e. It is important to recognize that the review of part of a proposal differs from the processing of requests for specific cost information (9-107), wherein the auditor provides information from the audit files without doing an audit of any

specific proposal. Paragraph 9-107 prohibits the use of the terms "report," "audit," or "review" in the subject paragraph.

9-109 Evaluation of Data Rights Proposals

a. DFARS 227.471, "Definitions," states that data developed under an Independent Research and Development (IR&D) or a Bid and Proposal (B&P) project is developed exclusively at private expense. Therefore, the government is entitled to only limited rights. In addition, the government is generally entitled to only limited rights to data developed under an indirect project account (manufacturing and production engineering, overhead, or G&A), unless it can be shown that such development was required as an element of performance under a government contract or subcontract. When the government requires unlimited rights to data whose development has been previously charged to IR&D or B&P, DFARS Subpart 227.4 authorizes the contracting officer to negotiate a fair and reasonable price for obtaining those rights.

b. In determining a fair and reasonable price, the contracting officer may request assistance from the DCAA auditor. However, the contractor proposals are not generally supported by cost or pricing data; therefore, the auditor's involvement in reviewing such proposals is limited. The auditor can verify to the books and records the amount claimed by the contractor as the cost of developing the proposed technical data (previously charged to IR&D/B&P costs, other indirect costs, or direct contract costs). The auditor can also review information regarding sales of the technical data to other parties, if any. If such sales have occurred, the government should not pay any more than the price paid by the contractor's most favored customer. However, the auditor cannot determine if the costs incurred under a claimed project or account relate only to the proposed data; nor can the auditor determine if there were other costs related to the data that were incurred under additional projects or accounts. The auditor

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also cannot be reasonably certain as to whether or not there is a specific contract or contracts that required development of some or all of the proposed data (such a determination would give the government increased data rights and possibly preclude the need to make the purchase).

c. As indicated above, the auditor will be unable to render an informed opinion regarding the reasonableness of the contractor's proposed price for data rights. DCAA audit will normally be limited to a cost or price verification. The report will

include a statement regarding the adequacy and compliance of the contractor's disclosed accounting practices. However, to be fully responsive to the contracting officer, the auditor should contact the requester upon receipt of a data rights audit request to discuss the specific agreed-upon procedures to be performed. Guidance for the application of agreed-upon procedures is contained in 9-108. The appropriate audit report format, including the disclaimer of opinion, is included in 10-300.

January 1995

Figure 9-1-1

Sample Format for Confirmation of Specific Cost Information

15 October 1988

MEMORANDUM FOR PROCURING CONTRACTING OFFICER,
DEFENSE FUEL SUPPLY CENTER

ATTENTION: PPK/John Smith

SUBJECT: Submission of Specific Cost Information Related to RFP No. DLA31-89-R-0001 The ABC
Company, Alexandria, Virginia

As you requested by telephone on _____, we gathered the following ABC Company data contained in our files
or otherwise readily available:

<u>Description</u>	<u>Amount</u>	<u>How Applied</u>	<u>Source</u>
Engineer	\$19.00	Rate per Hour	Weekly Labor Run 16
Design Engineer	\$20.50	"	"
Senior Engineer	\$25.00	"	"
Technician	\$16.50	"	"
Material Overhead	16.1%	% of Mat'l Costs	May 1988 Audit of a Previous Proposal
Labor Overhead	153.6%	% of Labor Costs	"
G&A	8.4%	% of Mat'l/Labor	"

The above information is only applicable to contractor fiscal year (CFY) 1988 and is based on the
contractor's annual sales volume of \$_____. These rates and factors may require adjustment if a pricing action
significantly affects the contractor's level of operation.

ABC Company information given above may be proprietary. The restrictions of 18 U.S.C. 1905 should be
considered before releasing it to the public. Also, this information should not be used for other purposes
without first consulting us regarding its applicability.

Any questions on this matter should be directed to _____ at telephone number _____.

Mary C. Simms
Branch Manager

Copy furnished:
DCMAO Alexandria/TM (ACO)
DCAA, Alex Br (PLA)

9-200 Section 2 — Evaluating the Adequacy of Cost or Pricing Data in the Proposal**9-201 Introduction**

a. This section provides criteria for determining whether the contractor/offeror has submitted adequate cost or pricing data in support of its price proposal. It also provides guidance for deciding what type of audit opinion should be used depending on the nature of the audit request and whether the cost or pricing data submitted by the contractor are considered adequate, inadequate in some respects, or wholly inadequate.

b. The objective in requiring cost or pricing data is to enable the government to perform cost or price analysis and ultimately enable the government and the contractor to negotiate fair and reasonable contract prices.

9-202 Definition of (Certified) Cost or Pricing Data

a. Cost or pricing data, as defined and further explained in FAR 15.801, consist of all facts existing up to the time of agreement on price which prudent buyers and sellers would reasonably expect to have a significant effect on price negotiations. In addition to historical accounting data, cost or pricing data include such factors as vendor quotations, nonrecurring costs, make-or-buy decisions, and other management decisions (e.g., from minutes of board of directors meetings) which could reasonably be expected to have a significant bearing on costs under the proposed pricing action. Cost or pricing data consist of facts which can be verified and should be distinguished from judgments (opinions based on facts) made by the contractor in estimating future costs. (Also see 14-104.)

b. Except as provided in FAR 15.804-2/DFARS 215.804-3, the (sub)contractor must submit a certificate of current cost or pricing data (in the format specified in FAR 15-804-4 certifying that to the best of its knowledge and belief, the cost or pricing data were accurate, complete, and current as of the date of final agreement on price of the (sub)contract.

9-203 Cost or Pricing Requirements

FAR 15.804/DFARS 215.804 contain the basic requirements related to cost or

pricing data, including the procedural requirements to be used when submitting cost or pricing data to the contracting officer or the contracting officer's representative. Subject to the exemptions listed in FAR 15.804-3/DFARS 215.804-3, the contractor is required to provide cost or pricing data whenever a pricing action will be over certain stated dollar thresholds (see 14-103.2). The contractor must submit this cost or pricing data with its SF 1411, Contract Pricing Proposal, either actually or by specific identification in writing. The mere availability of books, records, and other documents for verification purposes does not constitute submission of cost or pricing data.

9-204 Determining Adequacy of Cost or Pricing Data

a. Review the proposal to determine the adequacy of the cost or pricing data for review and evaluation purposes and advise the contracting officer whether the offeror has, in the auditor's opinion, met its obligation to submit adequate cost or pricing data (See 9-205). FAR 15.804-6(d) states that when certified cost or pricing data are required, this requirement is met if all cost or pricing data reasonably available to the offeror are either submitted or identified in writing by the time of agreement on price. However, neither this FAR provision nor the basic public laws describe in detail what constitutes submission or identification and how much data is enough data.

b. Use professional judgment when deciding whether all reasonably available data has been submitted or identified. The determining factor usually will be whether the submitted or identified data is considered accurate, complete, and current. If so, the cost or pricing data can be considered adequate and the contractor has met its requirements relating to cost or pricing data.

c. When the cost or pricing data are considered adequate and the proposal is prepared in accordance with FAR/DFARS (i.e., no cost principle deficiencies) and CAS (if applicable), then the proposal will usually be considered "acceptable" as a basis for negotiation of a

price. If there are inadequacies in the cost or pricing data, the auditor must decide whether the proposal, after proper adjustment by the contractor, can be used as a basis for negotiation of a price, or whether the impact is such that the contracting officer should be advised that the proposal should not be used as a basis for negotiation until specified corrective action(s) is completed.

9-205 Deficient or Denial of Access to Cost or Pricing Data

a. Support from the ACO and PCO is critical in successfully dealing with deficient or denial of access to cost or pricing data situations. These situations are often sensitive/complex and require extensive coordination between DCAA, the ACO/PCO, and the contractor. It is essential that the ACO and PCO have the maximum amount of lead time to resolve the conditions causing the deficiency or the denial of access to cost or pricing data.

b. When deficient or denial of access to cost or pricing data situations are encountered, the auditor should give immediate oral notification to both the ACO and the PCO (see 1-504.4 and 9-310) followed by written confirmation to the ACO with a copy to the PCO. Written confirmation should normally take place within 7 days of receipt of the contractor's proposal. When the auditor is to obtain a copy of the proposal from the contractor, no more than 3 days should be permitted for the contractor to furnish a copy. Notify the ACO and PCO if the contractor does not furnish the proposal within that time. The written confirmation shall include: (a) a description of the deficient or denied data or records, with copies of deficient data if requested by the contracting officer; (b) an explanation of the documentation or contractor action needed to correct the deficient cost or pricing data; (c) an explanation of why the documentation/denied data or records are needed; (d) the amount of proposed cost considered unsupported due to deficient cost or pricing data or to be questioned due to denial of access to records; and (e) the actions taken by the auditor to obtain adequate cost or pricing data. (Further guidance on access to records problems is in 1-504.)

c. There is no set formula for determining when cost or pricing data are so

deficient as to justify notifying the contracting officer. Depending on the specific circumstances, the auditor must decide whether one item alone or a combination of items justifies a notification. Examples of cost or pricing data deficiencies that would usually be reported to the contracting officer follow:

(1) Significant amounts of unsupported costs.

(2) Significant differences between the proposal and supporting data resulting from the proposal being out of date or available historical data for the same or similar items not being used.

(3) Significant differences between the detailed amounts and the summary totals (e.g., the bill of material total does not reconcile with the SF 1411).

(4) Materials are a significant portion of the proposal, but the contractor provides no bill of materials or other consolidated listing of the individual material items and quantities being proposed.

(5) Failure to list parts, components, assemblies or services that will be performed by subcontractors when significant amounts are involved.

(6) Significant differences resulting from unit prices proposed being based on quantities substantially different from the quantities required.

(7) Subcontract assist audit reports indicate significant problems with access to records, unsupported costs, and indirect expense rate projections.

(8) No explanation or basis for the pricing method used to propose significant interorganizational costs.

(9) No time-phased breakdown of labor hours, rates or basis of proposal for significant labor costs.

(10) No indication of basis for indirect cost rates when significant costs are involved.

(11) The contractor does not have budgets beyond the current year to support indirect expense rates proposed for future years.

d. If the cost or pricing data are so deficient that an audit evaluation cannot be performed, the auditor should consider recommending that the contracting officer return the proposal to the contractor. This approach is intended to permit the efficient use of audit resources. However, if the contracting officer decides not to return the proposal and indicates a

need for all available information, a properly qualified report will be issued by explaining the situation in the "circumstances affecting the review" portion of the report. The working papers file will document the contracting officer's reason for wanting a completed review of an inadequate proposal.

9-206 Application of Agreed-Upon Procedures

A price proposal audit request may call for only the application of agreed-upon procedures (9-102.1b). When an examination of this type is conducted, the audit report should, as part of the purpose and scope of review section, enumerate the procedures applied, indicate the intended distribution of the report, and comment on any known significant estimating system, internal control, and/or accounting system deficiencies. When the application results in no significant disclosure of inadequate cost or pricing data and no significant noncompliances with FAR and/or CAS, the report should disclaim an opinion with respect to the cost element(s) of the contractor's proposal (9-209.4). When the application of agreed-upon procedures discloses significant inadequate cost or pricing data and/or significant noncompliance with FAR and/or CAS, an adverse opinion will be issued (9-209.3). When the agreed-upon procedures cannot be fully applied due to government imposed constraints, and the auditor is unable to fully comment on the results of applying the agreed-upon procedures, the report should recommend that negotiations not be completed until all agreed-upon procedures have been applied.

9-207 Review of Specified Cost Elements

A price proposal audit request may call for an examination limited to those steps necessary to establish the adequacy of cost or pricing data related to a specified cost element(s) (9-102.1b). When this type of review is conducted, the audit report will clearly describe, as part of the purpose and scope section, what cost elements were reviewed and comment on any known significant estimating system, internal control or accounting system deficiencies. The audit opinion and report exhibits will address only the specif-

ic cost element(s) examined. As described below, the report opinion may be unqualified or qualified (9-209.1 and 9-209.2) when the cost or pricing data are adequate and the review discloses no significant noncompliances with FAR and/or CAS; or adverse (9-209.3) when the review discloses significant inadequate cost or pricing data and/or significant noncompliance with FAR and/or CAS. When the review cannot be completed due to government imposed constraints, and the auditor is unable to fully comment on the items included in the audit request, the report should recommend that negotiations not be completed until the requested cost element(s) have been reviewed.

9-208 Reporting Results of Review of Cost or Pricing Data

Once the auditor has completed his/her review of the cost or pricing data related to a proposal (or to the specific elements requested), a report using the format included in 10-300 will be issued. This report will include a summary and necessary supporting details for a clear understanding of the audit results related to the adequacy of the cost or pricing data. Any noted inadequacies in the cost or pricing data usually result in questioned, unsupported or unresolved costs, as discussed in 10-308. To the extent that fraud, other unlawful activity, or improper practices are found, (see Fig. 4-7-3 for examples of potential indicators), the procedures of 4-702.4 should be followed.

9-209 Types of Audit Opinions

In addition to reporting the results of the audit of the cost or pricing data, the reporting standard on audit opinion (10-103.3) requires that the audit report shall contain either an expression of the auditor's opinion regarding the financial statements or cost representations taken as a whole or an assertion to the effect that an opinion cannot be expressed (9-206). When applying this standard to cost or pricing data related to a price proposal, or parts of a price proposal, it means that an overall audit opinion will be given on the adequacy of the cost or pricing data submitted in support of the proposed cost to be audited and whether the proposal should be considered acceptable as a basis for negotiation of a fair and reasonable price. The standard al-

lows for three types of opinions. Examples of the standard opinion paragraphs used in price proposal reports are included at 10-304.3c. Detailed discussion of these opinions follows.

9-209.1 Unqualified Opinion

This type of opinion results when the submitted cost or pricing data are considered by the auditor to be adequate, acceptable and in compliance with applicable FAR/DFARS and CAS provisions. In this type of opinion, the auditor considers the cost or pricing data adequate and the proposal to be acceptable as a basis for negotiation of a fair and reasonable price.

9-209.2 Qualified Opinion

When inadequacies with the cost or pricing data, FAR/DFARS or CAS non-compliances, or problems not related to contractor actions or inactions (9-209.3) are noted, a qualified or adverse opinion is necessary. A qualified opinion states that, "except for" the effects of the matter to which the qualification relates, the cost or pricing data submitted or identified are considered adequate and the proposal acceptable for negotiation of a price. In determining whether a qualified opinion or an adverse opinion is appropriate in the circumstances, the auditor must consider the impact of questioned/unsupported costs on the negotiation of a fair and reasonable price and the extent of the corrective action the contractor should be required to undertake (see 9-209.3b and 9-210), and/or the significance of any situation not related to the contractor's action or inaction.

9-209.3 Adverse Opinion

a. An adverse opinion shall be rendered when there is denial of access to records/data having a significant effect on the audit, or when significant inadequacies or significant noncompliances requiring corrective action by the contractor prior to negotiation are noted. In these situations, it is the auditor's judgment that when taken as a whole (a) the submitted cost or pricing data are not adequate, (b) the proposal was not prepared in accordance with applicable acquisition regulations and (when applicable) Cost Accounting Standards, and (c) the proposal is, therefore, not acceptable as a basis for negotiation of a price. When an adverse opinion is expressed, the

opinion should include a direct reference to another paragraph/section that explains the item(s) causing the adverse opinion. This other paragraph/section in the audit report must explain specifically, fully and clearly the reason or reasons for the adverse opinion as well as the specific corrective action necessary to resolve the situation.

b. Situations where an adverse opinion may be justified generally fall into two categories: those resulting from the contractor's action or inaction and those not related to the contractor's action or inaction. Examples of each follow:

(1) Resulting from contractor's action or inaction.

(a) Significant amounts of questioned or unsupported costs which render the cost or pricing data inadequate as a basis for negotiation until the contractor completes specified corrective action(s).

(b) Accounting system deficiencies or estimating system deficiencies which have a significant impact on the proposal and preclude an effective audit.

(c) Noncompliances with CAS or FAR/DFARS which have a significant impact on the proposed costs.

(d) The contractor's denial of access to records, budgetary data, or performance data which are considered necessary to evaluate the proposal.

(2) Not relating to the contractor's action or inaction.

(a) Procurement imposed time constraint allows only a portion of the cost or pricing data to be reviewed, but does not allow sufficient time for obtaining competent evidential matter on which to base an opinion on the proposal as a whole (or for the specific elements to be reviewed in partial audit requests), and the procurement office will not or cannot grant an extension of the due date (see 10-103.1c).

(b) Significant amounts of unresolved costs due to the nonreceipt of assist audit reports covering the proposed subcontract costs.

(c) Nonreceipt of technical evaluation reports when the results of such reviews are considered necessary and are so significant that they may have a significant impact on the proposed costs (see D-301 and D-302).

c. In general, an adverse opinion based on the contractor's action or inaction will

normally result in a specific statement that the cost or pricing data are not considered acceptable as a basis for negotiations. However, an adverse opinion not related to the contractor's action or inaction normally does not result in a statement that the cost or pricing data are not acceptable as a basis for negotiations, but in a recommendation that the negotiations not be held until the reasons for the adverse opinion are resolved. For example, when significant unresolved subcontract costs are involved, the opinion statement should state:

"In our opinion, the unresolved subcontract costs discussed in (paragraph 2 or wherever discussed) above are significant enough to materially impact the results of the audit. Therefore, as discussed with (name and title of representative) on (date), we recommend that contract price negotiations not be concluded until the results of review of proposed subcontract costs are considered."

9-209.4 Disclaimer of Opinion

a. A disclaimer of opinion states that the auditor does not express an opinion on the audit area or submission reviewed. It is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an overall opinion on the audit area or submission being reviewed. An example includes the application of agreed-upon procedures during a review of a price proposal. The application of agreed-upon procedures is generally not sufficient in scope to express an opinion on the adequacy of the cost or pricing data reviewed. As a result, a disclaimer of opinion is usually expressed. However, a disclaimer of opinion should not be used when significant cost or pricing data inadequacies and/or FAR/CAS noncompliances are found during the application of agreed-upon procedures. In these circumstances, an adverse opinion would be used (9-209.3).

b. When disclaiming an opinion, the auditor should state that the scope of audit was not sufficient to warrant the expression of an opinion. An example of disclaimer of opinion follows:

"This report pertains only to the performance of the agreed-upon pro-

cedures discussed in paragraph 1. Because these procedures do not constitute an audit conducted in accordance with generally accepted government auditing standards, we do not express an overall opinion on the adequacy and compliance of the cost or pricing data submitted. In connection with the application of these procedures, no matters came to our attention that caused us to believe there were significant inadequacies or noncompliances related to the areas reviewed."

9-210 Criteria for Determining Audit Opinion Used

Accordingly, the cost or pricing data provided with the proposal (or for the limited elements/areas reviewed) may be completely acceptable (unqualified opinion), generally acceptable except for or subject to some specific minor deficiency (qualified opinion), or unacceptable (adverse opinion). As with 9-205b above, there is no set formula on when each type of opinion must be used. It depends on the auditor's judgment as to the significance of the problems noted. In other words, the auditor must consider the magnitude of the deficiencies found relating to the submitted cost or pricing data. If no deficiencies (i.e., inadequacies or noncompliances) are found, then normally an unqualified opinion would be appropriate. If minor deficiencies are found, this normally results in a qualified opinion. An adverse opinion would usually be warranted when the deficiencies are so significant as to render the proposal as a whole unacceptable as the basis for negotiation of a fair and reasonable price.

9-211 Reporting the Audit Opinion

Whichever of the three audit opinions is given (9-209), it should be reported as part of the summary portion (i.e., the "summary of audit results" section of 10-300) of the report. Necessary comments explaining the inadequacies in the cost or pricing data and how they influence the audit opinion are usually part of the "circumstances affecting the review" portion of the report. (This usually means these two sections closely compliment and cross-reference each other.)

9-300 Section 3 — General Evaluation Procedures for Estimates

9-301 Introduction

a. This section presents general guidance on evaluation of contractors' estimates including preliminary survey procedures and overall audit policies. Guidance related to specific cost areas is included in the remaining sections of this chapter (e.g., material cost is in Section 4 and labor cost is in Section 5).

b. This section is also intended to provide a general framework for the discussion on performing contractor estimating system surveys included in 5-1200.

9-302 Adequacy of Cost Accounting System

a. When the contract price is to be negotiated based on cost data, the contractor is required to certify that the data in support of the proposal are accurate, complete, and current (see 9-202b and FAR 15.804-2). The contractor's cost accounting system usually is a major data source used in preparing the proposal. In evaluating cost accounting system adequacy, the results of prior audits of materials, labor, indirect costs, budgeting function, etc., should assist in determining whether valid, reliable, and current costs are readily available (see 5-1207.3). When applicable, the contractor is also required to certify that it has filed a CAS Board Disclosure Statement, and that the practices used in estimating costs in the proposal are consistent with the cost accounting practices disclosed in the statement. In evaluating the cost accounting system, determine that the actual estimating practices comply with CAS and the disclosure statement (see Chapter 8).

b. To provide data required for cost estimating purposes, the contractor's cost accounting system must contain sufficient refinements to provide, where applicable, cost segregation for (1) preproduction work and special tooling; (2) prototypes, static test models, or mockups; (3) production by individual production centers, departments, or opera-

tions—as well as by components, lots, batches, runs or time periods; (4) engineering by major task; (5) each contract item to be separately priced; (6) scrap, rework, spoilage, excess material, and obsolete items resulting from engineering changes; (7) packaging and crating when substantial; and (8) other nonrecurring or other direct cost items requiring separate treatment. (See also 5-1207.3 and 5-1209.)

c. Accounting data used in developing estimated costs must be valid and reliable. For example, in an accounting system which provides for lot costing, inadequate controls over job lot cutoffs may result in inaccurate lot cost data. This type of error could produce inequitable results when lot cost trends are used in developing or evaluating costs for follow-on procurement. For this reason, a review of internal controls is important.

9-303 Contractor Estimating Methods and Procedures

a. A contractor's estimating method is influenced by the type of accounting system maintained and the statistical data available. Data supporting individual cost estimates may include (1) directly applicable experience for an entire product, such as a follow-on procurement for a product already in production; (2) directly applicable experience for certain tasks comprising a new procurement similar to those accomplished under previous contracts; and (3) general or indirectly applicable experience represented by various ratios and percentage factors applicable to a common base. When experience ratios or percentage factors are used by contractors to derive related estimates for a current estimate, determine whether adjustments were made to reflect differences in complexity, production rate, contract performance period, and other factors which influence the validity of the current estimate.

b. Contractors may employ uniform procedures to prepare prospective price proposals or may justifiably use a variety of methods and procedures. Special prob-

lems may require a deviation from established procedures. It may be desirable in certain instances, from both the cost and time standpoints, to use overall or broad estimating procedures, rather than more precise, detailed methods; or it may be necessary to rely on the judgment of qualified personnel in design, production, and other fields. Variations in estimating procedures employed may be attributable to such factors as (1) the relative dollar amount of each estimate, (2) the contractor's competitive position, (3) the degree of firmness of specifications related to a new item, and (4) the available cost data applicable to the same or related products/services previously furnished.

c. Regardless of whether the contractor has based an estimate directly on past incurred costs, ensure that cost estimates for future work are based on correction of any past or current inefficient or uneconomical contractor practices. For example, if the proposed engineering or manufacturing productivity is less than that reasonably achievable by the contractor in performing the proposed contract, the cost difference between the proposed productivity and the more likely achievable productivity should be questioned in the audit review. Also question the impact of any cost avoidance recommendations using the criteria in 9-308. (See also 5-1209.)

d. There are various methods of preparing cost estimates. The most frequently used are the detailed, comparison, and roundtable methods or a combination of the three.

(1) The detailed method requires the accumulation of detailed information to arrive at estimated costs and typically uses cost data derived from the accounting system, adjunct statistical records, and other sources. The information often includes specifications; drawings; bills of material; statements of production quantities and rates; machine and work-station workloads; manufacturing processes, including the analysis of labor efficiency, setup and rework, and material scrap, waste, and spoilage; data determining plant layout requirements; analysis of tooling and capital equipment, labor, raw material and purchased parts; special

tools and dies; and composition of the indirect cost pools.

(2) The comparison method is used when specifications for the item being estimated are similar to other items already produced or currently in production and for which actual cost experience is available. Under this method, requirements for the new item are compared with those for a past or current item, the differences are isolated, and cost elements applicable to the differences are deleted from or added to experienced costs. Adjustments are also made for possible upward or downward cost trends.

(3) The roundtable method is used to estimate the cost of a new item when there is no cost experience or detailed information regarding specifications, drawings, or bills of material. Under this method, representatives of the engineering, manufacturing, purchasing, and accounting departments (among others) develop the cost estimates by exchanging views and making judgments based on knowledge and experience. This method has the advantage of speed of application and is relatively inexpensive, but may not produce readily supportable or reliable cost estimates. When this method is used, technical assistance may be required to evaluate the resultant cost estimates.

9-304 Proposal Format and Support

a. Contractor price proposals required by FAR 15.804-1 through 15.804-6/DFARS 215.804-1 through 215.804-6 to be submitted with certified cost or pricing data must also be submitted using Standard Form 1411. Departments which contribute data to the proposal may include, among others, accounting, cost control, budgeting, estimating, planning, purchasing, production control, engineering, drafting, publications, and sales. In addition to the cost information contained in the accounting system, adjunct statistical records and data may be maintained and used in preparing cost estimates. The data may include bills of material, vendor quotations and catalogs, blueprints, value analysis reports, labor efficiency reports, sales budgets, and indirect cost budgets. Contractors may also

prepare time series charts, scatter charts, learning curves, and other forms of graphic analysis in developing cost estimates.

b. To expedite the review process, the Agency has developed criteria which can be used to evaluate the adequacy of the basic supporting data and information submitted with the proposal. This form is available on the FAO DIIS subsystem (file name ADEQUACY).

c. When coordinating with the responsible government procurement and technical representatives, solicit the contractor's cooperation in reaching an informal agreement on types of data and information to be submitted with a proposal or to be made available at the beginning of the audit.

9-305 Coordination with Contracting Officers

a. The organizational relationship of auditors with contracting officers and their representatives is discussed in 1-400. A close working relationship is essential for complete and meaningful evaluations of contractors' cost estimates.

b. Contracting officers, through proper coordination and utilization of members of the procurement team (including engineers, lawyers, price analysts, and contract auditors), must ensure that contractors' price proposals have been prepared on a sound basis and are reviewed in sufficient depth to support an informed opinion regarding reasonableness. The contracting officer is responsible for requiring the timely submission of needed data. Each member of the team is responsible for making recommendations in his or her respective area.

c. The auditor will perform financial reviews and analyses requiring access to the contractor's records. These reviews and analyses will cover both the adequacy of statements of current costs and the adequacy and reasonableness of projections to the extent information relevant to such projections can be obtained from the contractor's records. These evaluations, for example, might cover material prices and quantities; labor hours and rates; and the elements of the various indirect cost pools and their distribution.

As used in this paragraph, "records" include, among other things, historical cost records, cost ledgers, purchase orders, subcontractor and vendor quotations, budgets, forecasts, learning curve computations, and similar cost and forecasting data.

d. Administrative procedures to coordinate (1) a PCO request for audit review or technical review of a prime contractor price proposal or (2) an ACO, PCO, or auditor request for audit or technical review of a lower-tier contractor price proposal are described in 9-103, 9-104, 9-108, and Appendix D.

e. The manner in which information furnished by the auditor is used in negotiation is the responsibility of the contracting officer. Where the contracting officer fails to accept an audit recommendation and the auditor believes that this action has a significant or continuing impact on the reasonableness of the price or on administration of the contract, and in addition, feels that there is an opportunity for useful corrective action, the auditor should report the situation to his or her supervisor (see 4-803 and 15-600).

f. The type of contract to be awarded and the contract provisions are the responsibility of the contracting officer. When a review of the contractor's operation indicates that the contemplated contract type would not be in the government's best interest because of the contractor's type of business, accounting system, production of similar items for commercial purposes, or other reasons, recommend that the contracting officer consider a different type of contract. Also advise the contracting officer when proposed contract provisions appear inappropriate or undesirable (see 3-200).

9-306 Use of Specialist Assistance in Price Proposal Evaluations

a. An important aspect of a proposal evaluation is determining the reasonableness of material and labor estimates. Audit tests of these estimates may require the assistance of technical specialists.

b. Specialist assistance is usually obtained when the contractor's support for the cost under review is not based on accounting or financial data and the

auditor cannot efficiently or effectively determine the reasonableness of the costs through alternative means. However, the decision to use specialists should be reached only after considering the type of risk factors described in 9-402.2 and 9-501. These risk factors and others may indicate that specialist assistance is not necessary.

c. Detailed procedural guidance is presented in Appendix D to assist in (1) deciding whether technical specialist assistance is needed, (2) identifying what type of assistance is needed, (3) requesting the assistance, (4) achieving good communications with technical specialists, and (5) reporting on the use of technical specialists or the impact of their nonavailability.

d. Statement on Auditing Standards (SAS) No. 11, "Using the Work of Specialists," requires auditors to exercise professional judgment when the work of a specialist is required, including a determination of the type of technical expertise needed, and provides guidance on using the specialist's findings. It notes that while the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of these matters to determine whether the findings are suitable for corroborating the cost representations.

9-307 Incorporating Technical Information and Opinions Into the Audit Report

The contracting officer has the overall responsibility for determining how the information and opinions furnished are applied to the contractor's estimate. However, the auditor also has a responsibility for examining the report on any requested technical evaluation to ensure a reasonable understanding of the work performed, the accounting data relied on, and the impact of the results on proposed costs. Documentation requirements are in 4-1000. The work of a specialist should be incorporated into the report unless the findings are obviously unrealistic, or procedures used appear inadequate. In these

situations, attempt to reconcile differences with the specialist or, if necessary, the responsible supervisory official. Obtain the assistance of the ACO in facilitating a resolution. Discussion of procedures and technical aspects of the evaluation is usually sufficient to eliminate concerns. If the auditor is unable to resolve differences, the technical evaluation should not be relied on in the audit opinion or the development of questioned costs. The audit report should enclose the technical report and explain why it was not used (see Appendix D).

9-308 Incorporating Cost Avoidance Recommendations Into Price Proposal Reviews

a. In reviewing the reasonableness of proposed cost elements (including direct labor and material quantities and prices, other direct costs, and indirect costs), consider what it should cost to supply the proposed items assuming the offeror operates with reasonable economy and efficiency. Auditors use contract audit procedures where applicable to assist the procuring contracting officer in meeting his or her obligation (FAR 15.805-3(b)) to ensure that the effects of any inefficient or uneconomical contractor practices are not projected into future contract prices. Useful tutorial material on this concept is contained in the Armed Services Procurement Regulation Manual for Contract Pricing (ASPM No. 1), especially in section 2b.

b. Operations audits and other functional reviews performed as discussed in 14-500 provide one key source of information about inefficient or uneconomical contractor practices which should be considered in each proposal review. The audit program for each price proposal review will provide for assessing each cost avoidance recommendation from operations audits and other functional reviews at the contractor, to determine if there is a significant impact on the proposal. As circumstances develop (for example, the contractor implements a recommended cost avoidance or a cost avoidance proves not applicable to a certain product line), the proposal im-

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pacts can be expected to vary. Therefore, a reassessment should be made in each proposal review.

c. Any significant impact of cost avoidance recommendations will be reflected as questioned costs in the review of price proposals when all of these criteria are met:

(1) The findings and recommendations have been discussed with the contractor as provided by 4-304.5. It is not necessary to have issued the audit report on the functional/operational review, or have received the contractor's reaction to the findings and recommendations. However, the proposal impacts should be adjusted as these events occur, if they result in adjustment of the recommended cost avoidance.

(2) The proposal review has established that the recommended cost avoidance is applicable to the proposed contract performance and is not reflected in the contractor's estimated costs for the proposal. Note that a cost reduction may not be reflected in the proposal even though the contractor has agreed to make the needed improvements, or even if the recommendation has been implemented. Take care not to question costs (a) for a time period before the contractor could reasonably achieve the recommended economy or efficiency improvement, (b) for work areas where the recommendation does not apply, or (c) for proposal elements that adequately anticipate the expected cost reduction. Technical assistance (see 9-103 and 9-306) may be needed on these points, especially where the proposed costs are based on assumed future conditions or performance methods that would differ from those in effect when the cost avoidance recommendation was developed.

(3) The impact calculated for the specific proposal reasonably reflects the contractor direct and indirect start-up costs and investment amortization necessary to achieve the recommended cost avoidance, allocated using the contractor's established cost accounting practices.

9-309 Audit Review of Estimating Methods and Procedures

a. Evaluation of a contractor's estimating methods and procedures may be

divided into two broad areas: first, a review and understanding of the contractor's prescribed methods and procedures; and second, a review and understanding of the methods and procedures actually used in preparing the cost estimate. Work in these two areas may be performed concurrently or separately using, as a reference point, past or current cost estimates prepared by the contractor. In either case, consider the findings in both of these broad areas when planning and developing the audit program (see 5-1200).

b. The auditor's objective in these two areas is to examine the available data to the extent necessary to (1) form a sound opinion on the validity of the methods and procedures used to develop the cost estimates, and (2) make sound judgments on the extent and nature of testing to be done in areas requiring further examination. Also determine whether the results of recent estimating system survey work (5-1200) indicate that the estimating system is reliable enough to allow reduced audit effort on individual price proposals.

c. The extent of the auditor's evaluation may be influenced by the (1) experience gained in comparing earlier estimates with applicable actual costs, (2) degree to which the contractor's estimating procedures agree with the accounting procedures, (3) timeliness and depth of review given contractors' estimating methods and procedures by other government representatives, and (4) results of operational audits that affect future costs.

d. Recommend changes in estimating methods and procedures when the review indicates existing procedures are inadequate or improper.

9-310 Deficiencies in Specific Cost Estimates

a. This section deals with deficiencies in specific cost estimates versus deficiencies in overall cost or pricing data covered in 9-205. When any of the following deficiencies are encountered and are significant, the auditor should immediately notify both the ACO and the PCO in accordance with the guidance contained in 9-205.

b. Deficiencies in cost estimates may result from (1) the use of incorrect, incomplete, or noncurrent data; (2) the use of inappropriate estimating techniques; (3) the failure to consider or use all applicable factors or necessary techniques; (4) the improper use of an estimating technique; (5) an apparent deliberate concealment or misrepresentation of the data supporting the estimate either in the historical data from prior contracts or in the supporting documents prepared specifically for the proposal (see 4-700); or (6) the failure to estimate in a manner consistent with the disclosed or established accounting procedures as required by CAS 401 (see Chapter 8).

c. Upon discovering a significant estimating deficiency during a proposal evaluation, immediately prepare a draft estimating system flash report and submit it to the contractor for comment. The auditor should prepare the draft report and coordinate it with the contractor at the time the estimating deficiency is found, rather than waiting until the proposal audit is completed. This procedure will provide for issuing the flash report at the same time or shortly after the proposal audit report is issued. Give the contractor a reasonable amount of time to comment on the draft report, usually 1 to 2 weeks would be sufficient. Upon timely receipt of the contractor's response, a separate audit report entitled "Estimating System Deficiency Disclosed During Evaluation of Proposal No. XXX" (flash report) should be issued to the ACO addressing both the contractor's comments and additional auditor comments. If the contractor does not respond within the time-frame requested, the auditor should issue the estimating system flash report without the benefit of the contractor's response and explain in the report that the contractor was provided an opportunity to respond but did not do so within the available time. This flash report should address each deficiency disclosed in the proposal review that is either significant in dollar impact to total proposed costs or to specific cost elements.

d. Flash reports are not required if the estimating deficiency has been reported previously and the contractor's corrective action is currently being monitored by

the government. Such deficiencies are listed in the appendix to the proposal report, as described in 10-307.2, until they are resolved (DFARS 215.811-70(g)(1)). In addition, the explanatory notes of the price proposal audit report should describe the cost impact of any outstanding significant deficiency which affects the proposal.

e. Items that would normally be identified in an estimating system flash report when encountered include but are not limited to the following (also see 5-1204.2 and 10-307.2):

(1) The lack of clearly documented policies, standard procedures, and methods covering the contractor's estimating system. (Use judgment on the level of detail needed by small contractors with less than \$50 million per year in government sales.)

(2) Nonexistent, out-of-date, or inadequate support for factors used in the proposal (such as raw material, attrition, or normal production allowance).

(3) Failure to perform an adequate review of proposed subcontracts prior to submission of the proposal.

(4) The lack of budgetary data beyond the current contractor fiscal year.

(5) Contractor policies requiring that all production effort remain within the company, regardless of the comparative cost of the effort.

(6) Proposing material on a stand-alone basis without considering other known requirements (spares, related programs, other production lots) that might be ordered at the same time.

(7) Proposing costs based on vendor quotes without considering historical data indicating that prices ultimately negotiated with vendors are lower than the prices quoted.

(8) Not considering or selectively using historical cost experience for similar programs.

(9) Not considering residual inventories.

(10) Applying escalation to firm vendor quotes.

f. This flash reporting policy does not negate the requirement for in-depth analysis of estimating procedures and practices. Periodic estimating system reviews (5-1200) are still required. The frequency

of these periodic reviews may vary dependent upon the items identified in the flash reports.

g. When an estimating system deficiency is identified, consider whether the condition is likely to constitute defective pricing if not revised prior to negotiation and agreement on a contract price. If the auditor concludes the cost estimate is not current, accurate, or complete, take the following actions:

(1) Inform the contractor and request it take the necessary corrective action. Seek contracting officer assistance where applicable.

(2) When the contractor refuses to revise the cost estimate, attempt to obtain or develop the information through audit means.

(3) If the contractor is unwilling to correct potentially defective cost or pricing data and time or resource constraints make it impractical to sufficiently develop a recommended audit position, the audit report should advise the contracting officer of the inadequacies in the contractor's proposal (also see 9-205).

(4) For all proposals or other audits subject to U.S.C. 2306a, complete a Defective Pricing Lead Sheet (DCAAF 7640-22b) to rate the proposal for defective pricing potential. After completion of both parts, the original will be placed in the permanent file with a copy remaining in the audit working papers.

9-311 Review of Individual Estimates

a. As appropriate, procedures should include (1) a review of operations audit findings and recommendations, including cost avoidance recommendations that have an impact on proposed costs (9-308); (2) an analysis of reports of non-compliance with CAS and FAR Part 31 for possible application of the findings to proposal evaluations; (3) reviews of available written estimating procedures; (4) discussions with contractor personnel; (5) examination of the methods and procedures actually followed; (6) consideration of the data developed and the manner in which they were used; (7) comparisons of past cost estimates with incurred costs; and (8) analysis of cost trends.

b. Obtain information related to the following areas:

(1) The contractor's organization with emphasis on the various segments participating in cost estimating.

(2) The estimating methods and techniques actually used and the nature of the underlying data and judgments supporting each cost element.

(3) The attention given to special terms either contained in the request for proposal or to be imposed by the contract.

(4) The availability and use made of accounting, statistical, budgetary, and other data.

(5) The extent company-wide forward pricing factors are developed and used when preparing the cost estimates and whether these pricing factors are current (see 9-1200).

(6) The graphic analysis (such as time series and correlation charts) used in preparing the estimate.

(7) The degree of consistency between cost classifications used for cost accounting purposes (direct and indirect costs) and those used for cost estimating purposes, and the reasons for significant differences, especially on proposals submitted for like or similar items.

(8) The types of products manufactured and the manufacturing processes involved. This includes information from continuous monitoring of the manufacturing process for the effects of changes and/or modernization (see 14-800).

(9) The reliability of prior cost estimates, including a review of cost areas where significant differences exist between estimated and actual costs and the reasons for these differences.

(10) The contractor's managerial controls and review procedures (to ascertain whether cost estimates were prepared using established company practices).

(11) The relationship of the contractor's technical proposal to the cost estimate. The technical proposal may contain information such as descriptions of the items to be produced, production schedules, cost estimating plans, adequacy of tooling on hand, and the specific instructions furnished each department responsible for preparing cost elements contained in the proposal.

9-311.1 Review of Indirect Versus Direct Cost Classification

a. Review the contractor's cost classification for consistent treatment of cost elements to determine whether the treatment given direct and indirect costs in estimating parallels the accounting treatment of incurred costs as required by CAS 401 and 402. Inconsistencies should be reviewed and the reasons for different treatment explained. A violation should be reported as a CAS noncompliance.

b. Compare the pattern of direct and indirect cost treatment of the proposal under review with the current CAS Disclosure Statement and with other proposals recently submitted, particularly when the end items involve similar work. When the estimating basis is different, the difference should be thoroughly explored.

c. Differing direct versus indirect criteria among competitors and the exercise of special allocation provisions of certain Cost Accounting Standards requires that considerable attention be directed to consistency. Although differences are natural consequences of varying circumstances, be careful to avoid perceptions that inconsistent audit applications are causing or contributing to the accounting differences. Price proposal audit reports should clearly identify unusual cost accounting practices having a significant impact, particularly those requiring the use of any special allocation provisions.

9-311.2 Review of Consistency in Estimating and Accounting

CAS 401 requires that the methods used for estimating costs should be consistent with the methods used for recording or accounting for costs. However, examination might disclose, for example, that while actual costs are used in estimating costs, standard costs are used in recording costs. Under these circumstances, compare the amounts shown for a selected number of items extended at suppliers' actual prices with the amounts for the items obtained by applying established standards and related variances. This comparison should allow the auditor to evaluate the propriety of the cost estimate and to identify possible inequi-

ties resulting from using an estimating method which differs from the method used in accounting for costs. Similar comparisons could be made in other cost areas.

9-311.3 Comparison of Estimated and Actual Costs

When applicable, compare prior cost estimates with costs incurred. The information gained will not constitute conclusive evidence of the reliability of the contractor's cost estimating methods and procedures, but may disclose significant differences between estimated and actual costs. Reasons for the differences should be ascertained and considered in evaluating the reliability of the estimating methods/procedures and in determining the extent of selective tests in areas requiring further review.

9-311.4 Cost Realism Reviews

a. DFARS 215.805-70 requires contracting officers to analyze the cost realism of all technically adequate contractor submissions in response to cost-type competitive solicitations, even when adequate price competition exists. Contracting officers must determine whether the contractor has (1) fairly stated the price or (2) understated the price in order to "buy-in." FAR Subpart 3.501-1 defines "buying-in" as "submitting an offer below anticipated costs, expecting to . . . increase the contract amount after award (e.g., through unnecessary or excessively priced change orders)." Buying-in can result in cost growth or award protests by unsuccessful bidders that otherwise could have been avoided.

b. Contracting officers may request DCAA audit support in making a cost realism determination. Unlike the typical DCAA forward pricing review, which is generally focused more on ascertaining the allocability, allowability, and overstatement of proposed costs, DCAA cost realism reviews need to focus on determining whether the proposed costs are reasonable, credible, and compatible with the proposal scope and effort. In other words, the auditor needs to consider and specifically focus his or her cost realism review on the possibility that the contractor's proposed costs may be significantly

9-311.4b.

understated. Additionally, the report relaying the results of the auditor's cost realism review needs to clearly indicate that the contractor's proposed costs were specifically reviewed for reasonableness and possible understatement.

c. It is the contracting officer's responsibility to determine whether DCAA should be requested to perform a cost realism review. In the case of competitive, cost-type procurements, the contractor is not required to submit a Standard Form 1411 or to certify cost or pricing data. Furthermore, in some cases, the contracting officer (and, sometimes, the DCAA auditor) may be prohibited from entering into discussions with the contractor. If DCAA is prohibited from discussing the proposal with the contractor, this prohibition will most likely result in a highly qualified report that needs to be communicated up front to the contracting officer. The auditor should not be deterred by the unusual audit risk associated with cost realism reviews from meeting the needs of the requestor, as outlined above, in the most timely manner possible. It is the auditor's responsibility to be aware of the inherent risk involved in this type of procurement and to fully coordinate with the contracting officer regarding specific areas of risk, special procedures, and the appropriate audit service required to meet the needs of the request (e.g., Request for Specific Cost Information (9-107) or Review of a Part of a Proposal (9-108)).

9-312 Pre-Established Forward Pricing Factors

Formal or informal agreements between contractors and the government may exist which establish certain cost factors for use in forward pricing actions during specified time periods (such as forward pricing rate agreements and formula pricing agreements—a systematic method of pricing a large volume of small acquisitions). These factors may include indirect cost rates, labor hour rates, material and labor variances, material handling rates, and allowances for scrap and obsolescence. See 9-1200 and FAR 15.809 for detailed guidance on the review of forward pricing rate and formula

pricing agreements. Periodically determine whether present conditions or intervening occurrences negate current applicability of these types of pre-established cost factors. Circumstances which may adversely affect their continued applicability are changes in business volume, changes in market conditions affecting material or labor costs, savings accruing from cost reduction programs, changes in manufacturing processes used to make products, and changes in the accounting treatment of direct and indirect costs. Board of Directors minutes may document major decisions that affect the above areas (see CAM 5-109.2 and 14-605a).

9-313 Evaluation of Submissions (Estimates) After Costs Have Been Incurred

Under certain circumstances, a contractor's submission is evaluated after all or a portion of the costs have been incurred, such as in the case of pricing proposals, contract status reports, termination claims, and delay claims. In these cases, the review of the submission should not be limited merely to a comparison with the actual costs. Refer to the appropriate section of CAM for pertinent guidance relative to the specific audit being performed.

9-314 Estimates Based on Standard Costs

Guidelines for evaluating the validity of historical costs derived by using standard costs and related variances are contained in Chapter 6. The same guidelines apply when standard costs and related variances are used in preparing cost estimates. The basic principle underlying the use of standard costs in estimating is that the standard cost plus the estimated variance must reasonably approximate the expected actual cost.

9-314.1 Estimates Based on Revised Standards

A contractor may revise direct material and direct labor standard costs, adjusted by estimated variances, to develop direct

material and direct labor cost forecasts. Review the basis for revising the standards and decide whether the estimated variances have been properly adjusted to reflect the changes made in the standards. When revised standards reflect only certain historical cost changes, the related variances must be adjusted so that the two combined will approximate the anticipated actual cost.

9-314.2 Variance Analysis

a. Direct material and direct labor cost variances may be segregated by contributing causes (such as price and rate variances, use and efficiency variances, and variances caused by make or buy decisions) and by product lines (with homogeneous products) to produce reasonably accurate prime product costs. When variances are segregated, make comparative studies of historical costs and cost trends. For this analysis, consider employing techniques such as (1) time series charts, plotting the percentage relationship of a major direct variance element (material or labor) to related standard costs within the product line, and (2) improvement curves, plotting the unit or cumulative average direct material or direct labor costs (standards and related variances) for successive quantities of end products produced.

b. Measure the effect of anticipated changes so that historical costs may be adjusted to a basis comparable to that underlying the forecasts. Adjustments may be necessary when the following conditions exist:

(1) The planned production within a product line may be of a continuing nature, whereas, in prior periods, a number of related products were initially put into production causing high start-up prime costs.

(2) The planned sales and production volume within a product line may be substantially higher or lower than previous periods. Changes in volume have an impact on quantity discounts on direct material purchases, direct labor efficiency, and other factors which contribute to variances from standard costs.

(3) The planned reduction in inventories on hand may lead to unusual rework

effort and result in high nonrecurring variance cost.

(4) The planned changes in make or buy policies for specific components and in the product mix within a product line may have an impact on direct material and direct labor variances previously caused by a volume change.

9-314.3 Variances by Product Line

When standard costs and the related experienced variances are used by a contractor in estimating prime costs, establishing the reasonableness of the estimates will be difficult unless the contractor's accounting system provides for segregation of variances by product lines. Analyze recorded product line data to determine whether the contractor's estimate reasonably approximates expected actual costs. Available statistical analyses of the variances may provide more appropriate costs for specific products than recorded overall variances. Statistical data of this type may be used to appraise direct material or labor cost estimates based on applying overall variances to standard costs.

9-314.4 Consistency in Using Standards

When a contractor employs standard costs and submits multiple proposals, the direct material and direct labor standard costs should be consistent for pricing all procurements. Verify that standards are current before they are compared with cost estimates. However, these standard costs are generally not applicable for pricing items (1) not in continuous production, (2) being phased out of production, or (3) being produced under special production runs.

9-315 Review of Statement of Income and Expense

a. In some circumstances, the contractor's Statement of Income and Expense should be reviewed for each organizational element comprising a profit center with its own cost estimating and proposal responsibility. Consider for further study and operations audits areas of favorable or unfavorable results of operation. Comparisons should also be made to the contractor's budgets as discussed in 5-

500. In considering what areas might warrant further study, attempt to identify those factors which influenced operating results without reflecting on the soundness of the contractor's estimating procedures. Examples of these factors are unusually high profit rates compared with the estimated rates because of the introduction of more efficient production and management techniques, or unusually low rates of profit (or losses) resulting from deliberate low bids because of competition.

b. When a detailed study is to be made, obtain any further segregations of the income and expense statement that are available. This includes segregation by (1) commercial business; (2) government business; or (3) major categories of government business by product, contract, and type of contract. The analysis should compare the segregated data with the corresponding data shown in sales forecasts, company budgets, and cost estimates used by management in the conduct of the business.

c. Be alert to situations where the profit rates, based on an analysis of financial statements or other summary information, appear to be out of line (e.g., significantly higher than would be anticipated based on the profit rates negotiated). In these cases, determine the reason(s) for the high profits. Consider the results of this evaluation during future proposal, estimating system, and defective pricing reviews.

9-316 Review of Contractor Cost Controls

a. The adequacy and effectiveness of the contractor's system for controlling costs should be evaluated. This is done to decide whether the projected costs are being considered when preparing cost estimates. In other words, are there controls on the cost level used to control operational costs over a selected time period (budgets) and to do they achieve specific cost reductions (efficiency studies)? The evaluation of the cost controls should include the following:

(1) a review of the contractor's budget system—preparation of the budgets, operations covered, its use in controlling

costs, relationships of the various segments contained in the overall budget, and comparisons of past estimates with costs actually incurred; and

(2) a review of past, current, and planned cost reduction programs with emphasis on the nature of the programs, the cost savings achieved, and cost savings goals established for future periods.

b. Many major government contracts contain clauses requiring an approved cost/schedule control (C/SC) system for performance measurement on selected acquisitions (11-200). On proposals expected to result in contracts covered by DFARS clause 252.234-7001, Cost/Schedule Control Systems, or DFARS clause 252.242-7005, Cost/Schedule Status Report, when a contractor has proposed to use a previously accepted C/SC system, the auditor should provide comments on any deficiencies that are affecting the C/SC system on other contracts. These comments should include the impact of other contractor system deficiencies (such as those disclosed during audits of material management and accounting systems, labor, other accounting systems, budgets, and billing systems) that are being reported in C/SC systems surveillance reports (11-209). Provide the comments in an appendix to the proposal audit report (10-307.5).

9-317 Review of Cost Reduction Programs

a. Cost reduction programs include (1) value engineering, (2) work simplification, (3) design review, (4) time and motion studies, (5) organizational structure reviews, (6) suggestion and energy conservation programs, and (7) the Industrial Modernization Incentive Program (IMIP). These programs provide for greater economy and efficiency and may also indicate the effectiveness of a contractor's operations. Except for "value engineering," the general nature of these programs is adequately described in the titles. According to FAR 48.101, value engineering is a "formal technique by which contractors may (1) voluntarily suggest methods for performing more economically and share in any resulting savings or (2) be required to establish a

program to identify and submit to the Government methods for performing more economically. Value engineering attempts to eliminate, without impairing essential functions or characteristics, anything that increases acquisition, operation, or support costs."

b. In evaluating cost estimates, determine whether the contractor has considered specific cost reductions anticipated resulting from cost reduction programs other than value engineering. FAR Part 48 contains a discussion of the contract provisions that cover value engineering incentives and value engineering program requirements and their impact on pricing.

9-318 Review of Plans for Plant and Facility Improvements

Some contractors are accomplishing substantial technological advancements

on the factory floor. Improvements in the contractor's plant and facilities frequently generate substantial reductions in labor and material requirements. Review the contractor's plans and budgets for improvement of plant and facilities (see 14-600) during the proposed contract period and ascertain whether applicable production cost reductions are reflected in the cost estimates. The review should include evaluating the data submitted by the contractor to justify any new or additional government-furnished equipment or other facilities scheduled to be provided and the timetable for implementation of new equipment and manufacturing processes. The contractor's justification for these items normally will provide a good basis for determining whether applicable cost reductions are reflected in new work cost estimates.

9-400 Section 4 — Evaluating Direct Material Cost Estimates

9-401 Introduction

a. This section presents guidelines for review and evaluation of direct material cost estimates.

b. Direct material costs may include estimates for raw materials, purchased parts, subcontracted parts, packaging, freight, interdivisional transfers, vendor tooling, and other material directly identified with the engineering effort or the manufacture of a product. If the costs of scrap, spoilage, rework, process loss, obsolescence, and similar items can be reasonably estimated through the development of forward pricing factors or other means, then these should also be charged direct. It is important, however, to ensure that the method of estimating and costing these items complies with the applicable Cost Accounting Standards (see Chapter 8).

c. When direct material cost estimates are evaluated, the auditor should review both the validity of the estimated prices and the quantitative and qualitative material requirements. Appendix D and 9-306 provides detailed guidance on the technical review aspects of material cost estimates and the procedures for requesting assistance.

9-402 Material Estimating Methods

a. The method of estimating direct material cost depends on the type of accounting and statistical data available to the contractor and the bases for this data. The available data may be based on directly applicable experience for (1) an entire product, as in the case of follow-on procurement, or (2) certain parts and components comprising a product, as in the case of an estimate for an item substantially similar to or related to an item previously produced. The data may also be based on general production standards or on previous production experience. Examples include factors like direct material cost per pound of product and ratios of direct material to direct labor for similar products.

b. The four basic procedures for estimating direct material are: (1) estimate quantity requirements; (2) determine raw

material requirements, convert measurements as necessary, and estimate actual yields; (3) estimate current prices; and (4) adjust estimated prices for cost trends and quantities and project total cost. Note that prior to applying these procedures, the auditor should analyze individual material estimates from a qualitative perspective to ensure that the proposed material effectively satisfies the government's requirements.

9-402.1 Source of Material Cost Estimates

Information on which to base direct material cost estimates usually may be obtained from one or a combination of the sources listed below:

- a. Cost records, appropriately adjusted, for the last completed contract.
- b. Cost records for the last lot or a selected number of lots for the last completed contract.
- c. Experienced direct material costs, plotted on an improvement curve, for the same or similar product or components.
- d. Priced bills of material.
- e. Appropriately adjusted, priced bills of material for a related product.
- f. Direct material costs incurred for a pilot run of a prototype model.
- g. A prior cost estimate adjusted to reflect current needs.
- h. A budget prepared for the period during which the same or similar item was produced.
- i. Experience factors and ratios established for related or unrelated products of similar size and complexity.
- j. Operations time sheets.
- k. Engineering drawings.

9-402.2 Extent of Auditor's Evaluation

a. Direct material cost estimates should be evaluated based on a review of the validity of the estimated prices and the quantitative and qualitative material requirements. Factors which influence the scope of review include (1) the materiality of the proposed direct material costs, (2) the adequacy of the contractor's material related cost or pricing data (see 5-1200), (3) the adequacy of the contractor's estimating procedures for determining material requirements (see 9-1100),

(4) the extent to which actual estimating and material requirements practices follow established procedures, (5) the contribution of other government representatives in evaluating the quantitative and qualitative requirements for a specific proposal, and (6) the results of operations audits of material related functions. The contractor's classifications of direct materials in cost estimates must be consistent with classifications in the accounting system, as required by Cost Accounting Standard 401. Inconsistencies should be brought to the contractor and the contracting officer's attention so that appropriate action can be taken.

b. Whenever the auditor needs the assistance of a specialist to form an opinion on the measurement of costs, such assistance should be obtained. The auditor should (1) identify the specific type of assistance needed, (2) communicate with the technical specialist, and (3) assess the impact of technical specialist findings in formulating the audit opinion (see 9-306 and Appendix D).

9-403 Bill of Material

a. A properly prepared bill of material (BOM) generally will provide a sound basis for estimating direct material costs. The BOM will usually contain a detailed listing of the types and quantities required for raw material and for each component and part. It may also include allowances for expected losses; defects; spoilage during processing; scrap generated; common supply items such as welding rods, nuts, bolts, and washers; or other additives to the basic material requirements. When it contains only the basic material requirements, loading factors stated as a percentage of material costs may be applied to provide for expected costs of material losses and common supply items. The auditor needs to ensure, however, that the estimated costs supporting these loss allowances or loading factors are not also included in the contractor's indirect cost estimates in noncompliance with CAS 401 or 402 (see 8-401 and 8-402).

b. At some contractor locations there may be both an engineering and manufacturing BOM. The engineering BOM will list all parts required to produce the

end products. However, engineering may be unable to estimate certain quantity requirements such as length of wire. In such a case, manufacturing will develop detailed material requirements in the form of a BOM that will be used as a manufacturing aid. The auditor can use this to further define the material requirements of the engineering BOM.

c. Bills of material at large contractors are usually loaded into computer data bases which provide the capability to request information in many formats. Additional information such as description, where-used, item number, and dollar value may also be available in the data base.

d. A BOM can usually be provided for an end product or any subassembly. The most common sorts are:

(1) Part Number Ascending Order. This bill of material is sorted by ascending part number showing total quantity required for each part of an end item. A detailed report may give further information including where the part is used (see D-408.3).

(2) Assembly/Subassembly (Christmas Tree). This BOM is hierarchical and lists major assemblies followed by the various levels relating to subassemblies. It is often referred to as a "Christmas Tree" because of its pyramidal or Christmas tree shape (see D-408.3).

9-403.1 Evaluating Quantity Estimates

a. When the estimate relates to a follow-on procurement and prior experience exists, the audit review should include, but not be limited to, the following procedures:

(1) Obtain the engineering BOM that supports the contractor's proposal. An engineering BOM is preferable to a manufacturing BOM because of its correspondence to engineering drawings. If the auditor intends to select a manual sample of parts, an ascending/descending BOM with prices is usually necessary. Higher assembly information must be part of this BOM, or available in a supplemental document to ensure that the lower level parts are identified and verified to their appropriate higher assemblies. For a computer based bill of material, the part numbers may be in ascending/descending order or assembly/subassembly order.

9-403.1a.

The preferred method for sample selection is to use one of several available software tools including DATATRAK III.

(2) Determine that the bill of material is current and that, based upon the applicable specifications, it reflects all anticipated changes in the unit quantitative requirements.

(3) Prepare a sampling plan. Select for review either a random stratified sample or dollar unit sample of parts. Guidance on performing a sample is contained in Appendix B. Although the sample should be designed to validate bills of material quantities to engineering drawings, the sample should also be used to validate pricing to the extent that this is practical.

(4) Obtain detailed engineering drawings for the sampled parts. Separate engineering drawings may not be available for purchased parts, but may be available as part of the next higher assembly drawing. Also, an initial BOM may be incomplete and contain undefined parts which do not have engineering drawings. A large number of undefined parts usually indicates a need for technical specialist assistance.

(5) Compare sample part quantities and specifications (dimensions, tolerances, etc.) on engineering drawings to the BOM and note any discrepancies.

(6) Identify how the contractor calculated part quantities and the number of parts to be produced from raw material. Pay special attention to the contractor's use of "rounding" when calculating raw material factors. Verify the accuracy of the contractor's calculations by working through several part estimates and note any discrepancies.

b. When the estimate relates to a completely new product, the contractor may have only rough sketches or design prints for a prototype. The types and quantities of required materials may have been developed primarily based on the personal experiences and judgments of contractor personnel. Such estimates should be given close scrutiny because errors that duplicate material items are often found. Estimates for completely new products often require the use of technical specialists (see 9-402.2b).

9-403.2 Using Operations Time Sheets

An operation time sheet (see D-408.4) usually includes a description of the discrete manufacturing operations and associated times necessary to build the part, and may disclose material quantity, tools, fixtures and labor standards. They are a main source of labor information as discussed in 9-504.4. However, they may also be used as a substitute for a BOM for cost estimating purposes. Care should be taken when operations time sheets are used in conjunction with bills of material to ensure that costs are not duplicated.

9-403.3 Using Engineering Drawings

Material requirements are normally determined from engineering drawings. These drawings illustrate and provide essential information needed to design and manufacture a product. This includes: (1) physical characteristics, (2) dimensional and tolerance data, (3) critical assembly sequences, (4) performance ratings, (5) material identification details, (6) inspection tests, (7) evaluation criteria, (8) calibration information, and (9) quality control data.

9-404 Evaluating Contractor's Material Pricing Procedures**9-404.1 Sources for Pricing**

Sources for pricing components include (1) standard costs, (2) previous purchase order prices adjusted for quantity differences, (3) current vendor quotations, and (4) current order placement prices. In evaluating the contractor's pricing procedure, consider the following:

a. The sources of arriving at the prices used for each element comprising the total direct material estimate or the priced BOM.

(1) When the source is standard costs, determine whether the variance factor applied is realistic compared to past and current experience, and probable future trends.

(2) When prices are developed from previous purchases, identify the source of the prices (stock record cards or purchase orders) and ascertain if the prices used are current and appropriate for the estimated quantity required.

(3) When prices are developed from current vendor quotations, determine the

extent of bid solicitations and the reasonableness of prices submitted.

(4) Contractors generally maintain inventories of parts and components which are incorporated into regularly manufactured products. Inquiries should be made to ascertain the extent that available inventory has been considered in deciding the source of proposed material. When parts included in the inventory are to be used in the fabrication or production of items included in a proposal, verify the unit costs applicable to the inventory. Procedures for verifying inventory costs are included in 6-300.

(5) Regardless of the source used, compare the prices in the proposal with (i) those quoted by competing suppliers for comparable quantities, (ii) recent quotations for the same or similar items, (iii) costs incurred by the contractor for the same or similar items and (iv) the cost of any available inventory not specifically identified to other contractual requirements.

b. The type of subcontract or purchase order to be awarded. When conditions warrant the use of a cost-type or fixed-price redeterminable subcontract or purchase order, evaluate the price which the contractor has included in the estimate. Assistance of the auditor at the subcontractor location may be needed in making this evaluation (see 9-104).

c. The consistency with which the material pricing sources are used. When a variety of material pricing sources are used in costing the BOM, consistency in estimating procedures is not possible unless there are guidelines which closely define the governing factors. This becomes apparent when the contractor has a recurring, substantial dollar proposal volume. Closely scrutinize the propriety and reasonableness of material price estimates when there are inconsistencies in estimating procedures. Be alert for violations of the applicable Cost Accounting Standards.

9-404.2 Effect of Purchasing Procedures on Prices Paid

Economical buying practices generally result in obtaining the lowest prices for maximum quantities consistent with need, required quality, and delivery schedules. The contractor's purchasing

practices (see 5-1302) should be tested for reasonableness of quantities, quality, and the prices of direct materials, not only for parts in inventory, but also for parts required to be purchased under the proposed procurement. When current vendor quotations are used to support the contractor's direct material cost estimate, determine the extent to which the contractor followed economical buying practices. Vendor quotations should be examined to determine whether they were submitted in response to the procurement under consideration, and whether prices are appropriate in light of required quantities and specifications. When effective competition does not exist, as in the case of sole source vendors, the contractor's source for estimating material prices should be given close analysis.

9-404.3 Using Previous Purchase Order Prices

The contractor may use prices paid for the same items in previous purchases to estimate the material cost of follow-on procurements when current vendor bids have not been obtained. Determine the extent to which (1) recent purchase orders were selected to obtain applicable prices and adjusted, where necessary, to reflect price trends, (2) purchase order prices selected are for comparable quantities required for the follow-on procurement, (3) quantity discounts were given when increased quantities are to be purchased, and (4) consideration has been given to eliminating high start-up costs.

9-404.4 Pricing of Company-Produced Components

Under certain circumstances, contractors may propose materials and supplies based on price rather than cost when they are sold or transferred between any division, subsidiary or affiliate of the contractor under common control. In these cases, ascertain whether the specific circumstances meet the criteria described in 6-313. If the audit review discloses items that are improperly based on price rather than cost, appropriate adjustments should be made to eliminate the intra-company profit (plus any inapplicable indirect costs).

9-404.5**9-404.5 Pyramiding of Costs and Profits on Material Purchases**

a. Most major programs require the use of subcontractors, not only to obtain facilities and skills which may not be available within the upper-tier contractor, but to broaden the procurement base and to meet requirements for utilizing small business. However, the auditor should be alert to instances where a proposal may be excessive because of unreasonable pyramiding of costs and profits. This may occur between divisions, plants, or subsidiaries of a company or between subcontractors and upper-tier contractors. The contractor's procurement program should be reviewed to determine whether the planned subcontracting pattern is reasonable. The auditor should not limit his or her considerations to first-tier subcontracts, but should coordinate with auditors at subcontractor locations to disclose unreasonable pyramiding of costs or profits at any of the levels of the procurement chain where significant costs are involved.

b. Situations likely to result in excessive or unreasonable pyramiding of costs include the following (where questionable practices seem to exist, consult with government technical and procurement personnel as appropriate):

(1) Intra-company transactions through which items are charged to the contract at a list price (see 9-404.4) or at a cost plus unnecessary or unreasonable handling charges.

(2) Purchases from a subcontractor who acts merely as an intermediary/agent rather than as a manufacturer. Items may be drop-shipped direct to the upper-tier contractor's plant or they may pass through the subcontract plant for minor additions, changes, or testing which could be done more economically and as well at a lower or an upper-tier contractor's plant.

(3) Purchases by an upper-tier contractor of items which are identical with or similar to items being purchased by the government and which could more economically be supplied as government-furnished property.

c. When proposed material costs include loadings added by the prime contractor and upper-tier subcontractors, and the added amounts appear to be

disproportionate compared to their planned work contribution, the audit report should comment on the increased costs and profit attributable to the pyramiding. The report should state (1) the estimated savings which will result by eliminating the intermediary and shortening the procurement chain, (2) the considerations underlying the treatment of the direct procurement as government-furnished items, and (3) the degree to which the component or item involved can be treated independently from the system for which it is to be procured.

9-404.6 Subcontract Decrements

a. Vendor quotations and contract prices are frequently subject to change. These changes occur when: (1) vendors agree to make voluntary price adjustments and refunds in the event purchases exceed a predetermined level, (2) vendors agree to reduce a competitive quote, or (3) profits become excessive. If significant amounts of these changes are attributable to inefficient prime contractor purchasing practices, the auditor should recommend corrective measures be taken including: (1) improving the prime or upper tier subcontractor's purchasing practices and (2) recognizing the impact of the changes in cost proposals. The auditor at the prime or upper tier subcontractor level should also advise the auditor at the (lower) subcontractor level to reappraise the subcontractor's estimating procedures.

b. Information concerning patterns of reductions from quotes to actual prices paid may be useful in evaluating a cost estimate. Information about historical reductions is cost or pricing data and should be disclosed to the government. In addition, DFARS 215.811-70(d)(2)(ix) requires contractors to use historical experience when appropriate. Contractors should, therefore, analyze the pattern of historical reductions, determine its applicability to the subject procurement, disclose the analysis, and reduce proposed cost, if appropriate. None of these steps, however, relieves the contractor of its responsibility for performing cost or price analyses as required by FAR.

c. If there is a pattern of price reductions, review the prime contractor's or upper tier subcontractor's analyses of

quotes and subcontract prices. Determine whether the contractor considered the pattern in estimating material and subcontract costs. Evaluate the method used to analyze the price reductions. The contractor may apply a decrement to cost estimates based on patterns that are company-wide, program-wide, contract specific, or vendor specific. Ascertain what cost data were used to develop the decrement factor and confirm that the factor is properly and consistently applied to vendor-quoted base costs. For example, if the decrement factor was developed using both competitive and noncompetitive quotes, the factor should be applied to both competitive and noncompetitive quotes (See 10-308b). The data used to develop the decrement should be accurate, current, and representative. If the contractor has failed to use experience adequately in estimating costs, it may be necessary to develop a decrement for use in evaluating material estimates.

9-404.7 Using Trade Information

Regularly published trade information may be useful when evaluating the reasonableness of estimated prices. Information on industry-wide cost trends may also be useful, especially when contractors' estimates for follow-on procurement include increases in direct material prices based primarily on unsupported percentages. Information published in financial and industry papers usually reflects prices of basic commodities, trends and forecasts of wage increases by industry, and opinions by experts on economic trends. Trade publications can be of assistance in evaluating the contractor's material price estimates for aluminum and steel, especially when purchase orders are "future" commitments based on prices for the delivery date. Follow-on orders for large quantities may result in prices lower than are indicated by general market conditions discussed in trade publications because of quantity discounts or improved vendor efficiency.

9-404.8 Use of Consolidated Material Requirements

a. DoD Instruction 4245.12 (entitled, Spares Acquisition Integrated with Production — SAIP) specifies that when required in accordance with the Instruc-

tion, spare part orders are to be combined with prime contract orders for production components to achieve lower bill of material component unit prices. Furthermore, a review of previous direct material purchases (see 9-404.3) may disclose that bill of material components are required for two or more contractor programs. When appropriate, proposed bill of material component unit prices should be based on the total production schedule quantity requirements (i.e., for both production and spares).

b. When SAIP requirements are imposed by the contracting officer, the auditor will be requested to, as part of his/her overall proposal review, ascertain if the contractor or subcontractor has complied with the SAIP agreement. An evaluation, as determined by the auditor, will be conducted to ensure that prices for spares and identical items used in the production of end items reflect savings as a result of combined ordering.

9-405 Make or Buy Decisions

A contractor must decide whether to make or buy parts and components. Responsibility for this decision is usually delegated to key personnel from the production, tooling, engineering, accounting, production planning, and purchasing departments. Factors considered in arriving at a make or buy decision include (1) previous experience, (2) future requirements, (3) relative costs, (4) market conditions, (5) delivery schedules, (6) available capacity, (7) finances, (8) staffing, (9) subcontractors' capabilities, and (10) availability of materials. Review the guidance in 14-600 as part of the evaluation of the contractor's proposed make or buy decisions.

9-405.1 General Considerations

A contractor's make or buy decisions may have a significant impact on direct material cost estimates. In determining the scope and extent of the proposal review, evaluate the adequacy of the contractor's make or buy policies and procedures. This should include determining whether (1) the factors listed in the preceding paragraph have been considered, (2) the contractor was effective in communicating with its estimators to ensure that the estimate properly reflects

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the make or buy decisions, (3) past make or buy decisions reflected in prior estimates were followed, and (4) the results of operations audits of the various manufacturing functions involved in a make decision indicates any weaknesses.

9-405.2 Special Considerations in Make or Buy

Be alert to special factors involved in make or buy decisions. These include (1) intracompany procurement, (2) changes in make or buy, (3) simultaneous actions involving both the making and the buying of the same parts, and (4) an extensive time lapse between the proposal submission date and the actual contract date. These factors are discussed below.

a. Purchases by a contractor from one of its divisions, affiliates, or subsidiaries may be classified as either "make" or "buy" depending on circumstances. When the reimbursement to the subsidiary is on a cost basis, the purchase would be considered a decision to make the item. When the reimbursement is based upon a competitive price, the purchase would be considered as a decision to buy the item. Evaluate make items involving significant direct material estimates of the contractor and its subsidiaries, affiliates, and divisions. The cost estimates for make items should not include charges by both the affiliate and the contractor in areas such as engineering, field service, and product warranty. Evaluation techniques for buy items are similar to those used for competitive outside vendors. Special attention, however, must be given to determining whether contractor practices permit affiliates to obtain business by meeting the lowest bid submitted by outside vendors. This practice may not result in fair pricing and may reduce and tend to eliminate competition on future procurements. The audit report should include comments on any intracompany procurement practices which do not result in fair prices.

b. It is not unusual for a contractor to change make or buy decisions. When a contractor's plant facilities or those of its affiliates are not operating at full capacity there may be an incentive for the contractor to change from a decision to buy to a decision to make. A change from buy to make may require additional engineer-

ing, tooling, and starting load costs; additional labor operations with related indirect costs; and the elimination of the vendor price for the component. Conversely, a change from make to buy will result in the addition of a vendor price for the component and the elimination of direct labor and related overhead. In evaluating the estimated cost, determine whether the contractor has properly reflected the offsetting effect of changes in past make and buy patterns on all related cost elements in the proposal. If a proposed change in make or buy policy results in a significant increase in cost to the government, evaluate the contractor's justification for making the change. The auditor may ascertain the extent to which make or buy policies are changed, by comparing ratios of direct material to direct labor on current and prior procurements for the same or similar products. Discussions with contractor personnel responsible for make or buy decisions should provide the auditor with useful information. This information should also be noted for followup in subsequent operations audits of the area.

c. When a review discloses that a contractor makes and also buys the same part or component, determine the reasons for this practice and the propriety of the cost basis used for the material included in the proposal.

d. An extensive period may elapse between the proposal submission date and the negotiation date. Whenever feasible, determine through reexamination of data relating to make or buy programs whether significant changes have occurred in make or buy decisions during the interim period and whether these changes will affect estimated costs.

9-406 Evaluating Major Subcontractor Estimates

When the decision is to buy instead of make, subcontract costs will be reflected in the direct material portion of the contractor's cost estimate. In evaluating subcontract estimates, consider the contractor's procurement procedures, including controls exercised over subcontractors' costs and the type of subcontract or purchase order to be issued by the prime contractor. The prime contract auditor

will specifically review each pricing submission and available data to determine the need for any subcontractor/intracompany assist audits as discussed in 9-104 and 9-105.

9-406.1 Contractor's Procurement Procedures

a. Procedures employed by a contractor for evaluating subcontractor estimates may include using engineering departments to prepare independent estimates for comparison with subcontractors' price quotations and field reviews of subcontractors' quotations by company audit personnel or independent public accountants. The auditor must determine if the contractor's procurement procedures are adequate when planning the extent of his/her testing and evaluation (see 5-1302).

b. The auditor must also consider the result of operations audits of any related areas in making this appraisal. The contractor is usually concerned with obtaining the best subcontract prices available so that its proposed price will be competitive. However, if the prime contract is noncompetitive, give special attention to determining the adequacy of the contractor's procurement procedures.

c. The contractor is required to include the results of subcontract reviews and evaluations with its own cost or pricing data. Because of time constraints, however, the contractor might not complete the analyses of subcontracts prior to submitting its own proposal. In that case, ensure that reasonable schedules are planned to accomplish them and evaluate other actions by the contractor to assess the prices that its vendors have proposed. In an appendix to the audit report, list all subcontracts for which the contractor has not completed FAR-required cost analyses (see 9-104.1 and 10-307.7). If the contractor neither performs cost or price analyses nor takes alternative measures, an estimating system deficiency exists.

d. When a contractor's basic procedures are deficient, actual procedures do not conform with prescribed procedures, or when current data is not sufficient to provide a satisfactory basis for evaluating the reasonableness of the subcontract estimate, further testing of major subcontracts may be necessary. This may be

done by reviewing the available data at the contractor's plant or by arranging for an assist audit of the subcontractor's submission (see 9-104.2.)

e. When there is history on similar subcontracted components, the contractor should analyze its experience, determine the applicability of its experience to the subject procurement, disclose the analysis, and reduce its proposal, if appropriate. Failure to adequately use experience should be reported as an estimating system deficiency. If this occurs, review the purchasing department's files of previously negotiated subcontract prices or the results of prior assist audits and use previous exceptions or negotiation reductions in evaluating proposed subcontracts. The fact that reductions are not definite does not excuse the contractor from preparing an analysis or submitting such information as cost or pricing data.

9-406.2 Significance of Type of Subcontract or Purchase Order

The type of subcontract to be awarded should conform with the provisions of FAR Part 16 as they apply to prime contracts. The type of subcontract should influence the direction and scope of the audit work to be performed. For example, if a redeterminable or incentive type subcontract is contemplated, ascertain if the prime contractor has included anticipated subcontract ceiling prices or target prices in the proposed direct material cost. Subcontract ceiling prices do not constitute valid estimates due to the possibility that a lower price may ultimately be negotiated.

9-407 Material Cost Items Requiring Special Consideration

9-407.1 Government-Furnished Material and Reusable Containers

a. Become familiar with the types and amounts of material which will be government-furnished and verify that the contractor has not included cost estimates for such material in the proposal.

b. Review the estimated costs of packaging and shipping and segregate the costs included for containers. When the costs are significant, ascertain if reusable government-owned containers are available. This is an area where considerable

9-407.1b.

savings can accrue. For example, the auditor, in cooperation with the technical inspector, might determine that the cost to modify available government-owned containers would be considerably less than the estimated cost of new containers or that used containers of the type needed will be available at the scheduled shipment date.

9-407.2 Residual Inventories

When pricing a follow-on contract, consideration should be given to the ownership and value of materials which are residual from a preceding government contract and usable on the proposed contract.

a. Where the preceding contract is a closed cost-type contract, the residual materials normally will be government-owned and, if its use is contemplated, should be included in the proposal at no cost. However, the contractor should propose residual material from an open cost-type contract at actual cost. In these cases, the contractor should have internal controls to ensure that materials are transferred at cost if the new contract is awarded. Internal controls should be designed to protect the government from being billed more than once for the same material.

b. Where the preceding contract was fixed-price subject to price adjustment, terms of the settlement should be reviewed to determine ownership. If government-owned, the materials should be included in the proposal at no cost. If contractor-owned, it should be included at the lower of actual costs or current market price.

c. Title to materials residual from a firm fixed-price contract normally will rest in the contractor and the materials may be included in a follow-on contract, priced at the lower of actual cost or current market price. However, if there is a substantial amount of such inventory, it may be appropriate to comment on the amount of this inventory when reporting on a proposed follow-on contract.

d. The "Title" provision of the Progress Payments clause provides that those contract terms referring to or defining liability for government-furnished property shall not apply to property to which the government shall have acquired title

solely by virtue of the provisions of the progress payment clause. Upon contract completion, title to all property which has not been either delivered to and accepted by the government shall vest in the contractor under this clause. Special provisions of the contract or negotiation settlement may provide for other final disposition of any residual inventory.

9-407.3 Scrap, Spoilage, and Rework

a. The estimated cost of scrap and spoilage may be included by contractors in proposals as a direct cost, as a percentage factor applied to some other base cost, or as a part of indirect cost. Determine whether the contractor's accounting procedures give proper recognition to salvageable material generated under government contracts and whether the method of estimating scrap and spoilage cost is consistent with the accounting method for the proposed contract and complies with the applicable Cost Accounting Standards. Also, consider the economy and efficiency of the contractor's operations in the area. When the experienced scrap, spoilage, and rework costs on previous procurements for the same or related products are available, utilize this data in evaluating the reasonableness of the current estimate. Graphic analysis may be very useful for this purpose (Appendix E). A time series chart may be used to plot the movement of these costs or the percentage relationship to a volume base (such as direct material cost), on a monthly or less frequent interval. A scatter chart may likewise be groups of units produced. As a general rule, scrap, spoilage, and rework costs are higher during the early stages of a contract and reduce progressively as production techniques improve. In reviewing chart data, highlight those plot points which indicate abnormally high scrap, spoilage, and rework costs. The reasons for high costs should be analyzed and an appraisal made of the probability of their recurrence. Information of this type can usually be obtained from scrap committee reports or departmental efficiency reports.

b. Special attention should also be given to the contractor purchasing parts from surplus or salvage dealers, especially where the contractor has declared parts

surplus and then repurchases similar parts at a later date. This may indicate poor procurement practices and/or a condition reportable under 4-700 or 4-800. (In this connection, if the auditor encounters a situation where a surplus or salvage dealer proposes to furnish parts on government contracts using surplus parts that they acquired through normal government channels, report this situation to Headquarters, Attn: OPD, in accordance with 4-803.)

9-407.4 Process Loss

Process loss is the difference between the amount of material required at the beginning of a process and the amount used for the finished part. Scrap loss is defective material while process loss is the material lost during the manufacturing process. Process loss may be estimated using an overall factor, or separate factors for major subelements (such as trim loss, chip loss, and excess casting material). Bill of material quantities for items manufactured from raw material (such as sheet metal, bar stock and composite) frequently are adjusted to include process loss factors. As with scrap, determine whether (1) the contractor's accounting procedures give proper recognition to process loss material generated under government contracts, and if the loss is potentially significant; and (2) the method of estimating process loss is consistent with the accounting method for the proposed contract and complies with Cost Accounting Standards. When historical data on process loss is available, utilize this data in evaluating the current estimate. Graphic analysis as discussed in 9-407.3 may be useful. As a general rule, process loss rates should not vary significantly from previous contracts unless a new process or different material is introduced.

9-407.5 Obsolescence and Inventory Adjustments

a. Treatment in Estimates. Obsolescence and inventory adjustments may be included in cost estimates as percentage factors applied to a cost base or as a part of indirect cost. In reviewing the reasonableness of the contractor's costs for obsolescence and inventory adjustments, consider the following:

(1) The treatment of those costs for accounting and estimating purposes complies with applicable Cost Accounting Standards. This includes determining whether the estimates are valid for the method employed, and whether the treatment given the costs will result in an over-recovery by the contractor.

(2) The percentage factors derived from past experience as a basis for estimating costs of obsolescence and inventory adjustments. Ascertain the period used as the base and whether the contractor considered (i) the exclusion of nonrecurring and abnormal write-offs and (ii) transfers-back of obsolete material to productive inventory.

(3) The factors which may have caused obsolescence. Ascertain, distinguish, and evaluate the reasons for obsolete material. Obsolescence may result from engineering changes, or from material purchases in unreasonable quantities because of inadequate purchasing or record-keeping procedures.

b. Evaluation Guidance. Review and determine the reasonableness of the obsolescence factor contained in the cost proposal. Faulty procurement practices, inadequate records, inefficient store-keeping, or lack of standardization may result in unreasonable obsolescence estimates. When the charge for obsolescence appears unreasonable, recommend elimination of the unreasonable portion from the estimated costs. If the review indicates faulty procurement practices, recommend corrective action to improve the contractor's procurement practices and procedures. The condition should be noted for follow-up in a subsequent operations audit of the procurement function. When obsolescence is due to engineering changes, evaluate the loading factors based on current conditions. For example, when firm specifications have not been developed and the item to be made is in the development stage, the contractor's cost estimate may contain a relatively high obsolescence factor; on the other hand, the contractor's proposal should not include an obsolescence factor if the contemplated procurement is for an end item for which specifications are firm and no further change is contemplated. When circumstances justify the inclusion of a loading factor for obsolescence be-

cause of engineering changes, determine that over-recovery will not result because of inconsistencies in procedures followed in estimating and accounting. For example, over-recovery may occur if the contractor includes in his estimate a loading factor for obsolescence due to engineering changes and also includes the cost of the obsolete materials in his claim or proposal for an engineering change when materials are made obsolete by the change (see D-408.6e).

9-408 Using Material Cost Trend Data

9-408.1 Material Cost Scatter Chart

A graphic analysis and study of the trend of direct material costs per unit experienced in the manufacture of the same or a comparable product will assist in evaluating the costs included in estimates. Data plotted on time series charts may have only limited value when developing and studying trends of direct material costs, because there is generally little or no direct relationship between material cost and the time element. However, plotting the relationship on a scatter chart may reveal definite trends/patterns which can be helpful in evaluating direct material cost for additional units to be manufactured. When historical data include the direct material cost of the pilot run of a prototype, this cost should not be accepted as representative of the probable cost of succeeding production runs. Pilot runs may take place on the regular production line or in a model shop and may be aimed at simulating actual factory conditions; however, various production methods are often tested which contribute to abnormally high direct material costs per unit. High costs of pilot runs are generally the result of excessive scrap and spoilage, changes in material

specifications to better adapt the product to large scale production, and initial purchases of small quantities (see E-100).

9-408.2 Material Cost Improvement Curve

Using an improvement curve is generally associated with evaluating direct labor hour estimates, but may also be used in evaluating the estimated prices of direct material parts and components. Factors which may contribute to improvement in the direct material cost per unit include (1) job familiarization, which reduces the amount of scrap and rework loss, (2) lower prices as purchase volume increases, and (3) introduction of new sources and new aspects of material quality after the initial stages of test and experimentation. Consider the use of improvement curves for plotting vendors' prices for parts and components which are repetitively purchased. The plotting of quantities (unit or cumulative) versus billing prices may develop patterns which can be useful in arriving at reasonable prices to be paid for follow-on purchases. In evaluating the direct material cost portion of a prime contractor's proposal, the auditor may also plot prior related total material cost experience on log-log paper to ascertain if a measurable rate of improvement in the material cost per unit has occurred. Ascertain if the contractor's material cost estimate falls within a reasonable range of the cost indicated based on a possible or probable continuation of the experienced improvement rate. When the contractor's total direct material cost forecast or forecasts of costs of selected components are significantly higher than what the probable costs would be (based on a continuation of the related experienced material cost patterns), ascertain the reasons for the excess (see Appendix F).

9-500 Section 5 — Evaluating Direct Labor Cost Estimates**9-501 Introduction**

a. This section states procedures to be followed in evaluating direct labor cost estimates. Factors which influence the scope of audit include (1) the materiality of the labor cost, (2) the adequacy of the labor related cost or pricing data (see 9-200), (3) the adequacy of the contractor's estimating procedures for determining labor requirements (see 5-1200), (4) the degree of the contractor's compliance with its estimating procedures, (5) participation by other government representatives in evaluating labor costs, (6) results of prior operations audits, (7) reviews of Disclosure Statements, (8) compliance with applicable cost accounting standards, particularly with regard to consistency between estimating and accumulating costs (CAS 401), and (9) use of standard time methods.

b. If the risk factors described in 9-501a indicate problems or uncertainties about the way labor costs were proposed, it may be necessary to obtain assistance in reviewing technical aspects of the proposal. If so, refer to Appendix D which provides detailed guidance on the technical review aspects of labor cost estimates and the procedures for requesting assistance. Key elements of this guidance have been summarized and incorporated below.

9-502 Methods of Estimating Labor Costs**9-502.1 Basis for the Estimate**

a. Direct labor cost estimates can usually be grouped according to one of two methods used in developing the cost estimates. There are those estimates developed primarily from historical direct labor costs (see 9-503) and those developed primarily from the application of technical data (see 9-504). The method used in arriving at an estimate will depend on the nature of the procurement and the extent of the contractor's experience with the labor requirements of the proposed contract. When the contractor is proposing on a follow-on contract, the

labor estimate should be based on prior labor experience, adjusted for expected changes for future work. When the contractor is proposing on a research and development contract or a production contract for which the contractor has no prior cost experience, the auditor should expect the labor estimate to be based on technical data.

b. Although there is little uniformity in the way contractors categorize labor for the purpose of estimating costs, direct labor can generally be grouped into three major categories (1) manufacturing, (2) engineering, and (3) support. For estimating labor requirements and costs within these categories there are many techniques which may be used. Selection of the most appropriate estimating technique and use of high quality estimating data are necessary to produce reasonable and accurate labor estimates. Seven of the most common techniques listed in order of increasing estimating accuracy are (1) judgement and conference, (2) comparison, (3) unit method, (4) factor method, (5) probability approaches, (6) cost and time estimating relationships, and (7) standard time method (see D-407.2).

c. Labor cost estimates based on historical data are generally developed through one of the following methods: (1) comparison, (2) unit method, (3) factor, and (4) cost and time estimating relationships. Labor cost estimates based on technical data generally use (1) the judgement and conference method, (2) probability approaches and (3) standard time methods.

d. The most common type of data used in preparing labor cost estimates are: (1) actuals for the same or similar item or activity; (2) labor standards with adjusted historical efficiency factors; (3) standard cost with forecast adjustment factors; and (4) tentative, judgmental, or rough estimated hours.

9-502.2 Classification of Labor

Although classification of labor costs as a direct or indirect charge may be the same for cost estimating and cost ac-

counting purposes, the classification of labor cost for estimating purposes usually is determined by the basis used to develop the overall estimate. When labor cost estimates are extrapolated from the recorded labor costs, the labor classification in the estimate will follow quite closely that used in recording labor costs. When labor cost estimates are developed from technical data, all labor attributable to furthering the prime requirement under the prospective contract may be considered direct labor; while labor engaged in support of the contract activities may be considered indirect labor. Either basis of labor classification may be present in any specific case. The auditor must evaluate and report on the direct labor cost estimates within the classification framework used by the contractor but should be alert for possible over or under recovery of costs because of deviations from applicable cost accounting standards, inconsistencies in the classification and treatment of labor costs, and in the development of labor rates applicable to individual cost estimates. Inconsistencies are likely to occur in the treatment of nonrecurring, contingent, or special labor cost items. Deviations, when combined with weaknesses in the internal cost estimating controls, can result in duplication of labor costs within the estimate by inclusion in both the direct and indirect labor categories.

9-503 Labor Cost Estimates Based on Historical Cost

When historical cost data are available, the estimated direct labor cost will probably be a projection of that data. Such a direct labor cost projection should not be accepted merely on the assumption that the cost pattern or trend will continue unchanged during the period of the proposed contract. It is necessary to consider other related factors, some of which are discussed below.

9-503.1 Current Nature of the Labor Cost Data

a. Factors which affect the productivity of labor normally will not be the same today as they were last week or last month. It is not sufficient to use labor

costs accumulated in the past, adjusted only for changes in the labor rate, or to use the labor cost for the last job lots produced; the last job lots may well include labor cost incurred over an extended period of time. The cost data used in the estimate should be based on current experience, adjusted for anticipated reductions, modernization of manufacturing processes and practices (14-800), or other variations, and developed in accordance with the applicable cost accounting standards.

b. The objective in evaluating the base used by the contractor for the projection of a direct labor cost is to arrive at an amount which would represent today's cost for performing each direct labor task. In the case of standard costs, this occurs when the current normal variance, rather than the average variance over an extended period, is used as the base. Plant and personnel records should be reviewed for changes in labor efficiency or pay rates which would not be reflected in current cost data. A relatively simple check would be to compare the most recent cost for individual labor operations with that used by the contractor in developing its estimate.

9-503.2 Guidance for Evaluating Estimates Based on Historical Data

The first step in evaluating labor estimates is to determine and assess the basis which the contractor used to estimate costs. The contractor's proposal should identify the sources of data, the estimating methods, and underlying rationale used. The contractor should analyze and use historical experience where appropriate. If the labor estimating technique applied makes use of historical data, the following steps should generally be performed:

a. Identify the historical data used to develop the labor cost estimate.

b. Ascertain the reliability and accuracy of the data. Audits of timekeeping and labor charging practices previously performed by the office may provide the needed level of understanding and confidence.

c. Evaluate the content of the data to assure that it is representative and contains all costs that are purported to be

there. Compare supporting data to other sources of historical information such as operational staffing. Inconsistencies may indicate exclusions of pertinent historical data. Determine whether valid reasons exist for excluding data.

d. Test for consistency of data over a given period. Look for accounting system changes, reclassification of costs from direct to indirect and vice versa, and consider the results of previous cost accounting standard (CAS) reviews. If the data is inconsistent (either historically or prospectively), the auditor should request the contractor to make appropriate adjustments.

e. Assure that nonrecurring costs are removed from historical data. Pay special attention to manufacturing setup costs which are lot quantity sensitive. Other nonrecurring costs may be in the historical period, but are not expected to occur in the forecast period. These costs should not be used to estimate future costs.

f. Assure that other non-representative data are excluded. For example, some historical inefficiencies may not be expected to recur. Likewise, some historical events are unique and should not be used as a basis for predicting future costs.

g. Make sure the data is current. Data which is too old may not reflect expected conditions (e.g., facilities, equipment, management, organization, modernization of manufacturing practices and processes, and staffing). Several years of historical data may be useful in identifying important trends.

h. Assure that historical data is obtained from the same facility where the proposed end-item or product will be manufactured. If the data was obtained from a different facility, determine its acceptability for estimating purposes.

i. Examine the relationship between lot costs and equivalent units produced. If the relationship is not consistent, it may indicate either changes in production (e.g., engineering design changes, make vs. buy changes) or inaccurate measurement of equivalent units in beginning and ending inventories.

j. Draw a conclusion regarding the suitability of historical data for making estimates.

9-503.3 Labor Cost Trends

When evaluating the direct labor cost estimate, ascertain whether the contractor, in arriving at the labor cost projection, considered seasonal, "learning," and other factors that cause trend fluctuations and analyze the historical labor data covering a sufficient period of time and in sufficient detail (by departments, production centers, or processes) to disclose seasonal trends. One of the more common reasons for fluctuations in labor costs is the periodic overloading and underloading of plant facilities. Whether fluctuations in historical labor costs should be reflected in the projection and, if so, whether they should be averaged or treated individually, can be determined only by analysis and review of the contractor's direct labor and associated experience and proposed plans which might affect labor costs. It should not be assumed that past trends will continue, rather, the auditor should judge whether the conditions that produced the current trend are likely to continue and, if so, how such conditions will affect future costs. The use of any reasonable correlation of facts will assist in determining the presence of a labor cost trend and evaluate its causes, as a condition for projecting that trend. Correlation analysis and similar techniques (see Appendix E and Appendix F), when applied to cost centers or production areas, usually will disclose significant trends in labor costs or in the relationships between labor costs and changes in labor efficiency.

9-503.4 Nonrecurring Labor Costs

Nonrecurring costs usually are not disclosed by a routine audit of labor costs. Nonrecurring costs; e.g., the temporary production of a part normally purchased, are frequently obscured because they are usually treated and charged as direct labor costs without further identification or segregation. Review of labor costs for selected tasks, jobs, or cost centers not associated with a normal job or process and a review of job lot records for unusual jobs may reveal nonrecurring costs. When the current estimate provides for nonrecurring costs, the auditor should weigh the probability that the

costs will materialize. If it is considered likely that the cost will be incurred, the auditor should evaluate the reasonableness and allocability of the costs. If it appears unlikely that the costs will be incurred, they should be questioned.

9-503.5 Engineering Change Costs

Cost reductions resulting from prior engineering changes and included in recorded costs should be evaluated in estimating costs of follow-on procurement. The auditor should determine that the cost of expected engineering changes which will be priced as contract changes are not provided for in the current proposal. A review of the language in the invitation for proposal and related correspondence may indicate that the production requirements are less than definitive, and that modifications will be necessary in the future.

9-503.6 Setup Time Cost

a. The auditor should ascertain the types of labor which the contractor normally classifies as setup time costs and review the method of accounting for such costs before evaluating the estimates of direct labor for setup time. Setup time costs are the costs required for changing over a machine or method of production from one job to another, and include the time for tearing down the previous setup and preparing the machine or process for the new operation. Setup may also include the time for the production and inspection of the first acceptable piece or test group of pieces. The time required to clean up the work area during or at the end of a production period is not included as setup time, except when it is necessary to make regular readjustments of a setup during the production cycle. The readjustment time may be charged either as production or setup time, depending on the contractor's accounting policy and the extent of the readjustment. When the setup for a process job is recorded as the first operation on an operation sheet, the time and cost may be similarly charged. The possibility of overlapping and duplication in the estimates of setup, teardown, handling, cleanup, and other setup cost elements which may

or may not be charged as direct labor should be considered in each review.

b. Adequate segregation of setup costs by categories such as departments, jobs, product lines, components, and operations will enable the auditor to make comparisons between the estimated setup time and costs for new procurements, and the actual time and costs for previously produced products of the same or similar type; and between a specific estimate and the actual setup time costs. Results of the comparisons should assist in evaluating the overall acceptability of the contractor's direct labor estimates for setup time and costs. The auditor should have a general knowledge of the caliber of labor required to perform the setup work in order to appraise setup costs. There is little comparison; for example, between the setup requirements for a tape controlled milling machine and those for a simple drill press. Knowledge of such factors will enable the auditor to more accurately appraise the efficiency and cost effectiveness of the estimated setup time. This is particularly important when the contractor uses a single setup cost rate as a rule-of-thumb method for computing setup time.

c. In reviewing the estimate for setup cost, the auditor should determine whether an approximate optimum number of items is scheduled for each production run and whether the estimated number of setups is reasonable. He or she should also consider factors affecting the size and frequency of production runs. These include the length of time over which delivery is to be made, the number of production lines, the number of production shifts, production scheduling, machine utilization, production capacity, tooling requirements and the tools available, and competing demands for the use of production facilities.

d. The contractor's procedures for planning setups in determining the efficiency and reasonableness of setup time costs should be reviewed. Estimates for setup costs should take into account the disruption in production or time lost for the use of facilities for other purposes during prior setup operations. Comparison of predetermined efficiency setup targets with actual costs for each setup

provides a means for measuring setup efficiency and cost effectiveness.

9-503.7 Applicability of the Labor Cost Data

Cost data used should be directly applicable to the proposed contract. When the estimate is for the continued production of a product currently or recently produced, the applicability of the cost data can be determined by examination of operation sheets and production schedules and plans. The auditor should examine, on a selective basis and in cooperation with government technicians, blueprints, product specifications, and contemplated production methods for the new product. When appropriate, contractor personnel should be interviewed to ascertain probable significant changes in engineering production methods and the effect those changes might have on current cost data. When a review indicates that significant technological changes have occurred since the cost data was accumulated, adjustment of experienced costs is necessary before projecting the experience cost pattern. Adjustment of the direct labor cost experience is especially important when the estimate applies to a product that is relatively new or has been materially modified from that produced in the past. The auditor should be alert to features of the contemplated production that might indicate a significant deviation from the normal labor pattern and its effect on the cost data.

9-503.8 Variances in Labor Cost Estimates

Variances between estimated and actual cost are generally a consequence of either human error or changed circumstances. They can result from (1) careless accumulation of supporting data, (2) incorrect design information, (3) unexpected delays causing premiums to be paid for overtime, (4) unexpected processing problems requiring deviation from the manufacturing plan, (5) failure to rework preliminary estimates to produce an accurate finished estimate, (6) reliance upon estimators who are not familiar with job processes, (7) making a "guesstimate" and then "padding" it to protect against unanticipated costs, (8) failure to

consider all quantities being built, and (9) inappropriate use of learning curves or other techniques.

9-504 Labor Hours Based on Technical Data

9-504.1 Coordination with Technical Representatives

a. Under appropriate circumstances, the auditor may make an adequate appraisal of a direct labor cost estimate through the use of labor cost data. However, because of the relationship of cost data with technical data, the appraisal should not be confined to labor cost data alone, but should include an evaluation of the technical aspects of a proposal by examination of production data, plans and related engineering data. When resorting to the use of technical data, the auditor should coordinate his or her efforts with technical personnel.

b. Whenever the auditor needs the assistance of a specialist to form an opinion on an element of the measurement of costs which is not an accounting or related financial subject, such assistance should be obtained. The auditor should (1) identify what type of technical specialist is needed, (2) decide upon the best source for the technical specialist assistance, (3) achieve good communications with the technical specialists, (4) assess the impact of technical specialist findings upon the audit opinion, and (5) report on the uses of technical specialists or the impact of their nonavailability. (See 9-306 and Appendix D.)

9-504.2 Guidance for Evaluating Estimates Based on Technical Data

Specific areas in which the auditor may make inquiry, either in anticipation of coordinating with the technical representative or conducting the review independently, include a review of (1) the labor hour estimate, (2) operation time and shop methods, (3) operation time standards, (4) the contractor's labor productivity, and (5) applicability of Military Standard 1567A. Further guidance on each of these five areas is provided in subsections 9-504.3 to 9-504.7.

99-504.3**9-504.3 Labor Hour Estimates**

Conditions influencing the contractor's use of technical data to estimate labor hours include: (1) the elimination of supplementary assembly lines originally established to accommodate temporarily accelerated production schedules or other emergency measures; (2) the introduction of more efficient and cost-effective material issuing and handling procedures to eliminate or prevent bottlenecks and reduce work stoppage; (3) improved techniques in the training of employees; (4) more efficient transfers of employees between assembly lines, work areas, departments, shifts, and jobs; (5) modernization of manufacturing processes; (6) the introduction of new manufacturing machines; and (7) the introduction of special tooling. To determine whether labor hour estimates reflect recently improved conditions, the auditor should compare current labor operation sheets with those in prior periods and with those reflecting advance production schedules.

9-504.4 Review of Operation Time Sheets and Shop Methods

When the contractor is unable to support its estimate with experience data, the auditor should seek other justification from the contractor, such as technical determinations, to assist in appraising the reasonableness of the data and bases underlying the cost estimate. A review of operation time sheets or similar documents which reflect the estimated time required to perform each production operation generally will in the aggregate provide a basis for evaluating the estimated direct labor hours included in a contractor's cost estimate. Appraisal of the data contained in the operation sheets, requires familiarity with the contractor's products, plant organization and processes, manufacturing operations, tooling, machines, and the manufacturing complexities of the product. Operation time sheets should reflect current shop methods, production planning data and the most current time studies. The auditor should determine that the operation time sheets do not include as direct labor, operation which will be recorded

as indirect labor and whether provisions for contingencies have been included in the estimate, especially in costing a new product. These and similar inclusions, if not justified, will result in an overstatement of the estimated direct labor hours and violate CAS 401 and 402. Documents supporting operation time sheets and production control records should be examined and discussed with government technical personnel.

9-504.5 Operation Time Standards

a. Operation time standards (i.e., the predetermined estimates of the time required to perform each operation) are usually reflected in operation sheets. These standards may or may not represent the same time factors used to develop the accounting standard direct labor costs or the actual labor costs as recorded in the contractor's cost accounting records. To perform a more meaningful evaluation, the auditor should determine the relationship between operation time standards and direct labor standards established for accounting purposes.

b. The basis for establishing operation time standards may vary depending upon company policy. Contractors may base standards on the number of units which can reasonably be produced by an employee under normal or average operating conditions; or may establish ideal operation time standards (i.e., standards based on nearly ideal conditions-as a means of encouraging maximum productivity). The auditor should review the contractor's time study methods and other bases used to establish time standards for each operation and should also review factors other than operation time, such as provisions for rework, setup, and other nonoperational time which may have been included in the standards. Information of this type can be of value in appraising the reasonableness of cost data, such as the efficiency factors used to modify the operation time standards in arriving at the estimated number of direct labor hours for a specific proposal.

c. To illustrate: a contractor employing operation time standards based on attainable conditions, may compile monthly efficiency reports which indicated a 90 percent departmental efficiency factor.

This productivity experience may be considered reasonable and in keeping with management expectations. On the other hand, where ideal operation time standards are established, a 60 percent departmental efficiency factor may be reasonable.

d. The auditor will find that operation sheets may or may not reflect a lower cost per unit for successive production lots. The auditor should determine whether a downward trend is present or is likely to develop and, if so, whether it has been reflected in the cost estimate. Time series diagrams and correlation studies of departmental efficiency rates which disclose short or long range trends will assist in the evaluation of the labor estimates. When labor cost standards-as used in the contractor's cost accounting system-are based upon data reflected in operation sheets, a time series analysis of monthly product labor efficiency variances will assist in determining the existence of a trend.

9-504.6 Labor Productivity

a. Within limits, the productivity of direct labor, as measured by the quantity of product produced by a specified volume of labor, normally increases as production continues. The improvement may be due to the adoption of improved methods and tools or the increased efficiency of the individual worker. The amount of improvement per unit of product generally is high during the early part of the production cycle and decreases as production is stabilized, processes are refined and additional experience is gained. After production has stabilized, the rate of improvement may not be measurable except over a substantial period of time. When semiautomatic or automatic machines are used, production may become completely stabilized and the rate of improvement will approximate zero until a change is made in the product or in the production method. As production tapers off near the close of a period of stabilized production, labor productivity tends to decline toward a negative improvement rate. Reduction in production effort may be due to the wearing out of jigs and tools, the transfer of the more skilled workers to new jobs,

or a slackening of effort by the remaining workers.

b. The auditor's primary interest in labor productivity is in measuring current productivity and past trends, and determining the causes of past trends so that the likelihood of continuance during the contemplated production period may be assessed. Causes and effects can be separately measured, provided the change is sufficiently pronounced and not obscured by other factors. A change in tools or the introduction of a highly improved production process might be related to a specific reduction in the required labor hours; or a change in design might be related to an increase in labor hours. Factors which affect productivity operate interdependently, and it is difficult to evaluate separately the effect of any one factor. However, an overall measurement of productivity may be made by correlating labor hour requirements with related successive quantities of output. One method of measuring the overall change in productivity is by the use of the improvement or learning curve. This technique and its application to direct labor hour estimates are discussed in Appendix F.

9-504.7 Military Standard 1567A and Work Measurement

a. MILSTD 1567A establishes a contractual requirement for an integrated and disciplined work measurement system on manufacturing operations. When applied with a positive management commitment, experience shows that MILSTD 1567A has achieved improved productivity and cost control. It applies to prime production contracts exceeding \$20 million annually or \$100 million cumulatively. When the standard applies to a prime contract, subcontracts exceeding \$5 million annually or \$20 million cumulatively are also covered. Ship construction, research and development, and service-type contracts are exempt.

b. MILSTD 1567A requires contractors to implement a proper work measurement system. Contractors are required to meet predetermined minimum work measurement system requirements of accuracy, coverage, consistency, documentation, and audit. Any weaknesses

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inherent in the work measurement system which impact the accuracy of labor estimates must be fully documented and provided to the government.

c. The auditor will be able to utilize the required documentation of MILSTD 1567A to review proposed labor costs and operations audits. MILSTD 1567A earned hour standards must reflect the labor required to build the current product design with the existing production methods, assuming no production difficulties. Detailed variance analysis from MILSTD 1567A will identify causes of existing inefficiencies and corrective action plans to overcome them. The auditor should incorporate these analyses into an evaluation of the proposed labor costs or recommendation for operational improvement (see D-407.4).

9-505 Evaluation of Estimated Direct Labor Rates

a. Direct labor rates used to estimate direct labor costs may be at expected individual or expected average rates. The latter rates may be either separately estimated for each proposal or pre-established for pricing many proposals submitted over a given period of time. There is wide variation in the methods and extent to which contractors combine the various direct labor grades and functions and associated pay rates for the purpose of cost estimating. Variations arise because of differences in the type, size, and importance of labor operations; in the type and arrangement of production facilities; in the manner and extent of departmentalization; and in the type and dollar values of government and commercial contracts and products.

b. In the evaluation of direct labor rates, both individual rates and average rates, consideration should be given to hours worked in excess of 8 hours per day or 40 hours per week by salaried employees, particularly in the evaluation of fixed price proposals. Estimated labor rates may be based on the number of hours available during a year using an 8 hour day and a 40 hour week. However, reviews of actual labor hours incurred may have determined that salaried employees generally work in excess of 8 hours per

day and 40 hours per week. The estimated direct labor rates used should therefore reflect the total hours the employee is expected to work during the year. See 6-410.

c. A new solicitation provision and contract clause, DFARS 252.237-7019, Identification of Uncompensated Overtime, was issued in December 1991. This provision applies only when service contracts are being proposed. It defines "uncompensated overtime" as "hours worked in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act (FLSA), without additional compensation." Service contracts are usually awarded on the basis of the tasks to be performed rather than the number of hours to be provided. However, if a service contract is awarded on the basis of the number of hours to be provided and the contractor proposes "uncompensated overtime" hours, then this solicitation provision requires the contractor to identify in its proposal the "uncompensated overtime" hours and rates. This includes "uncompensated overtime" hours that are in indirect pools for personnel whose regular hours are normally charged directly. This DFARS provision also requires that:

(1) the contractor's accounting practice for estimating "uncompensated overtime" be consistent with the accounting practice for accumulating and reporting these hours, and

(2) the contractor include a copy of its policy on "uncompensated overtime" with its proposal.

d. Auditors should notify contracting officers of any apparent noncompliance with the DFARS requirements, specifically, if the contractor proposes uncompensated overtime hours but fails to identify the number of such hours and corresponding hourly rates. Auditors should also notify contracting officers if the contractor fails to submit a copy of its policy addressing uncompensated overtime with its proposal.

9-505.1 Individual Employee Labor Rates

a. Individual rates may be used when the persons who will perform the work under the proposed contract are known.

A determining factor in the award of a contract may be the "know-how" of specific individuals, and their agreement to perform the work under the contract. In other cases, individual rates may be used when the procurement under review requires a caliber of employees whose pay rates are not representative of the average rates paid within their labor classifications.

b. While the use of individual rates in cost estimating will produce precise results, average rates within labor classifications are generally developed and employed for practical purposes. Either approach may result in reasonable estimates provided a consistent practice is followed and deviations will not affect proper recovery of anticipated costs.

9-505.2 Average Labor Rates

a. The development of average labor rates by contractors may include a single plant-wide average or a separate average rate for a function, grade, class of labor, cost center, department, or production process.

b. The use of average rates is generally warranted because within each unit of an operating plant there is usually a labor norm and cost pattern for each production situation and associated group of workers. Average rates, properly computed and applied, will express the labor norm and equalize the effect of the indeterminable factors usually associated with other methods. The use of average rates is preferable, for example, when the contractor is unable to project with any degree of reliance the (1) identity of those who will perform each operation and correspondingly the individual rates of pay; (2) exact production processes to be used, particularly when the contractor has no applicable experience; and (3) precise labor requirements.

c. The inclusion of inapplicable types or quantities of labor in the computation of an average rate is not in itself reason for not accepting the rate. The auditor should determine whether the inclusion significantly distorts the average from the probable norm for the contemplated production.

d. It would be improper for a single average to combine equal quantities of

high- and low-cost labor if they were not to be used equally in production, or to compute an average group of pay rates without weighting; that is, without regard to the number of employees receiving each wage. The use of weighted averages is necessary to give proper effect to all factors.

e. There are a number of methods for computing weighted averages. A generally accepted method is to obtain weighted averages from the total projected payroll for each production unit for the contract performance period adjusted for any abnormal labor cost conditions.

f. In summary, factors which the auditor should consider in evaluating proposed average labor rates include (1) the reasonableness and acceptability of the labor classification; (2) the probability that relatively the same grades of labor will be used in performing the contract as were used in developing the estimate, and the probable effect of any material deviations; (3) the accuracy and propriety of the method used in computing the averages; (4) the impact on the average rates of projected increases or decreases in the general level of labor costs; and (5) the significance of any deviation from past practices in developing the rates, in their application, or in the normal and proposed methods of distributing costs when incurred.

9-505.3 Pre-established Labor Rates

a. Value of Pre-established Labor Rates. Contractors may estimate labor rates for use in computing the estimated direct labor cost portion of all proposals to be submitted during a specified period of time. The contractor may estimate the production labor hours for a contract and compute a cost estimate by applying an average labor rate for each manufacturing department, production function, or type of labor. This procedure is inexpensive and is a workable procedure because it (1) recognizes a continuing uniformity in the manufacturing process within a plant, which has considerable validity, especially when separate rates are used for each production function and (2) promotes consistency in estimating methods and compliance with applicable cost accounting standards. (See 9-1200 for

99-505.3a.

general guidance on forward pricing rate agreements.)

b. **Limitations on Pre-established Labor Rates.** Labor rates are not applicable to all businesses or to all labor conditions or manufacturing processes within a business. The customary use of labor rates by a contractor in developing direct labor cost estimates does not make their applicability automatic. There are definite limitations on the use of such rates. Their use is based on the assumption that the manufacturing process is relatively stable and prior labor usage patterns are not expected to change significantly in the future. The use of labor rates must be examined in each case to determine whether the contemplated production methods and requirements parallel the conditions as to labor usage presupposed in the development of the rates, or whether conditions are present which indicate that the rates should be modified or rejected. This appraisal must be made even though the rates have been approved on an overall basis by government procurement activities. The audit report should contain appropriate comments whenever the review of labor rates discloses that the rates are unreasonable or not properly applicable to the work to be performed.

9-505.4 Rate Impact of Contractor's Labor Usage

The auditor usually can expect, in the absence of indications to the contrary, that production labor norms will be applicable insofar as factors such as the pay differentials for unskilled labor, longevity, efficiency, piece work premium, and shift premium are concerned. The same assumptions cannot be made for factors such as the pay differentials for skilled workers, specialists, technicians, engineers, and others. Usage patterns vary and variations are often due to the nature of the production involved. The auditor therefore must consider both current usage and future labor plans. The proposed and probable labor patterns for production under the contract must be considered. The auditor must also think about the consistency of those patterns with other plans for the prospective production period; the availability of the various

classes of labor; and the normal methods of using, assigning, recording, and charging the labor costs to commercial and government products and contracts. Significant deviations from the normal pattern should be supported by adequate justification for the auditor's consideration in evaluating the estimates.

9-505.5 Use of Permanent Audit Files

The effect of pay differentials and usage factors may be evident from a review of the proposal, the supporting papers, and production plans. The operation and effect of other factors may require an examination of past proposals and experience on corresponding contracts; sales forecasts; long- and short-range budget plans; facility usage plans; and labor, hiring, assigning, and training programs. A current record of findings should be kept to reduce the amount of review work and to facilitate the coordination and integration of the auditor's examination of each proposal with the contractor's over-all operations and plans. This is particularly helpful when the auditor reviews a number of proposals submitted by one contractor or performs a number of audits of one contractor's records over a period of time. For example: examination of the permanent files may indicate that a current proposal contemplates a higher than normal labor-hour cost based on the intention to use only top grades of engineers for a part of the proposed production. The permanent file records for other contracts and pricing proposals for the same period may show that costs were based on average rates which also included the wages of the same top grades of engineers for the same periods of time. Identification of inconsistencies, such as shown in this example, requires close integration of current and past examinations and is essential in the evaluation of labor cost estimates.

9-505.6 Trends of Labor Rate Experience

a. The current average hourly rates paid for each labor classification may be used by contractors as a starting point for computing future rates. These should be verified by examining current payroll records.

b. The average rates should be adjusted for any planned or expected changes in the wage scale and any trends that may be present in the historical pattern or that can be expected to carry forward into the contemplated production period. This will require an analysis of the historical labor and payroll data for a period of time sufficient to disclose any trend that may be present. The analysis should be in sufficient detail by intermediate periods to disclose significant deviations from the trend as well as the pattern of any periodic deviations that have a material effect on the trend.

c. The period to be covered by the analysis cannot be predetermined. Seasonal and longer term fluctuations generally require that experience factors be examined for a minimum of two business years. A longer period of time may be necessary in special circumstances. However, the use of a longer period will not necessarily increase the validity of the trend data developed because changes in organizational structure, size or composition of the labor forces, general economic conditions, and other factors affecting the rates may be encountered over a long period; these factors may not be appropriate for consideration when estimating rates for future periods.

9-505.7 Factors Influencing Validity of Average Labor Rates

a. Personnel Policies and Actions. The auditor should review and evaluate the effect of proposed personnel actions on the estimated average hourly labor rates and determine whether actions which have a material effect on these rates are in accord with the normal personnel policy, and whether resulting rates are reasonable.

(1) Wage Agreements. The auditor should determine whether consideration has been given to the terms of all current wage agreements and prospective changes. In evaluating agreements which provide for changes based on cost-of-living indices, the auditor should analyze current and past trends and determine their future significance. Information contained in the labor rate reports published by the Bureau of Labor Statistics, Department of Labor, Washington D C,

and by state and local agencies may furnish data for this type of analysis.

(2) Other Personnel Actions. It is not practicable for the auditor to isolate and measure the precise effect of every personnel action on average hourly rates. Merit increases, promotions, and changes in size and composition of the labor force occur continually, are interrelated, and have a cumulative effect on average hourly rates. The auditor should review the composite effect of the personnel actions and determine whether any over-all current average hourly rate trends exist which will continue during the contemplated production period or whether there are indications that new trends are likely to develop. The major factors should be analyzed and the trend indicated by each type of action determined even though the effect of each action on the average labor hourly rate cannot be measured directly. The possible effect of personnel actions on average hourly rates may be estimated by relating each major action with the over-all change in average hourly rates through the use of graphic techniques such as time series diagrams and correlation analyses. These techniques and their application to average direct labor rate estimates are discussed in Appendix E.

b. Change in Labor Force. Changes in the size and character of the labor force affect average pay rates. These changes accompany increases or decreases in production volume. A material increase in volume usually will result in a decrease in the average rate because of new hirings at lower entrance level or at rates below the average. The opposite result can be expected when production volume decreases. The first groups of employees to be separated are generally in the lower pay levels of their respective labor classifications. The possible effect on labor cost of a contractor's plans to increase or decrease the labor force because of changes in production volume can be estimated by correlating past changes in the number of personnel and changes in the average pay rates for each plant unit or labor class. In evaluating planned changes in the number of personnel a further correlation might be made of the labor force or labor payroll with produc-

tion volume, as measured by units, cost of sales, or other means.

c. Multishift and Overtime Operations. When reviewing average labor rates the auditor must consider multishift and overtime operations. Premium payments for multishift and overtime may have a direct effect on the average direct labor hourly rates, depending on the method used in classifying and distributing costs. When premium payments are recorded

as overhead, they should not be reflected in the average direct labor hourly rate. When treated as part of the direct labor charge, premium payments should be segregated from average direct labor hourly rates. If not segregated, fluctuations in the amount of premium pay will tend to distort any trend or other data developed in analyzing changes in the regular pay rates.

9-600 Section 6 — Evaluating Other Direct Cost Estimates**9-601 Introduction**

This section provides guidance for evaluation of estimates of the various types of costs usually referred to as "other direct costs."

9-602 Definition of Other Direct Costs

a. An other direct cost (ODC) is one which by its nature may be considered indirect but which, under some circumstances, can be identified specifically with a particular cost objective (i.e., a product, service, program, function, or project). ODCs may properly include, in varying degrees, the three basic elements of cost: labor, material, and indirect cost. It is quite common, however, to find items included as ODCs that should be classified as one of the three basic elements. Therefore, it is important to scrutinize all items in this area for compliance with disclosed accounting practices and Cost Accounting Standards (CAS).

b. Costs classified by contractors as ODCs vary in treatment, but may often include among others (1) engineering, (2) special tooling, (3) packaging, (4) travel and subsistence, and (5) field service.

9-603 Objectives and Scope

a. The audit objectives when reviewing ODCs are to determine whether (1) the contractor's classification is proper, (2) the underlying data in support of the estimates is valid, current, and applicable, (3) the costs as reflected in the estimates are reasonable, (4) the costs are estimated using acceptable procedures applicable in the circumstances, and (5) the contractor has properly considered all factors which might have a bearing on the validity of the estimated costs.

b. The scope of the auditor's evaluation of ODCs will depend upon (1) the significance of the amount, (2) the adequacy of the contractor's procedures for estimating costs, (3) the degree of uniformity in estimating procedures, and (4) the consistency of estimating procedures with dis-

closed accounting procedures and CAS. Some contractors consider ODCs as being directed wholly toward the production of complete end products and consequently do not include these expenses in cost estimates for spare parts. Others contend that spare parts production has an impact on both the types and amounts of these expenses, and therefore provide for such estimates in spare parts proposals. Regardless of which method is followed, determine the propriety of ODCs for either end products or spare parts and verify that the method of treatment complies with disclosed practices and other CAS requirements.

9-604 Evaluation Considerations and Techniques

The contractor may include in ODCs, costs referred to as start-up, design and production, and continuous or maintenance engineering. To perform an effective evaluation, the auditor must have a knowledge of the contractor's practices, policies, definitions, concepts, accounting treatment, results of prior operations audits, and estimating methods (see 5-1200) that effect ODCs. Guidance applicable to factors which should be considered in evaluating ODCs are contained in the following paragraphs.

9-604.1 Application of Percentage and Conversion Factors

a. Packaging, field service, and various types of engineering and tooling costs may be estimated by applying percentage to some other basic cost or conversion factors (e.g., number of staff-hours per month) to basic estimates of required staff-months of effort.

b. In reviewing conversion factors applicable to direct labor hours per staff-month, for example, ascertain whether the contractor considered excluding time for holidays, vacations, sick leave, idle time, and similar items of an indirect nature. Failure to make proper allowance for indirect time in the conversion factors normally results in overpricing the con-

tract, and noncompliance with CAS 402 where applicable.

c. Percentages and conversion factors may be applied separately for each estimate, or they may be submitted or proposed periodically for incorporation in all proposals. In either instance, and notwithstanding previous agreements, evaluate the propriety of percentage and conversion factors for applicability in the current proposal.

9-604.2 Government-Furnished Material

In some cases, the government will furnish materials or services to the contractor on a "no charge" basis. Government-furnished materials may include special tools, shipping containers, or other items which may be classified by the contractor as ODCs. In these cases, verify that estimated costs for government-furnished materials are not included in the proposal.

9-604.3 Use of Accounting Data

Contractors' accounting records which provide reserve accounts for ODCs based on the quantity of end products produced or shipped, may be used in evaluating estimates. When reserve accounts are maintained, credit entries are based on estimated amounts per unit applied to the quantity of end products produced or shipped. Debit entries are made for the expense actually incurred. An analysis of these reserve accounts should assist in determining the reliability of the contractor's prior estimates. Large credit balances may indicate overestimating and large debit balances may indicate underestimating actual costs.

9-604.4 Analytical Techniques

a. Various analytical techniques can be used in evaluating the reasonableness of ODCs. Graphic analysis usually is an appropriate evaluation tool for studying experienced cost patterns as they relate to various types of ODCs. Time series charts are useful in depicting the experienced movement of expenses or percentage factors related to some base cost over a time period. Scatter charts are used to show linear relationships of a specific other direct cost to some other volume base to which it bears a close correlation.

b. The comparative analysis technique may be applied using as reference points available engineering data, budgets, loading charts, previous proposals for similar items, and industry standards and experience.

c. When the contractor's proposal contains significant engineering or tooling staff-hour estimates, the estimates can be compared with related staff-hours specifically identified with the directly chargeable total plant engineering or tooling labor base used in the computation of the proposed engineering or tooling overhead rates. When the use of analytical techniques discloses significant differences, obtain further information from the contractor in support of the estimate. When differences cannot be adequately justified, the audit report should contain appropriate comments and recommendations.

9-605 Specific Evaluation Considerations

Expenses generally classified as other direct costs (ODCs) and audit considerations related to them are discussed in the following paragraphs.

9-605.1 Engineering

Engineering costs included as ODCs generally fall into two categories—design and production. The type of engineering effort included in each of these categories depends on the individual contractor's practices. Because engineering effort required for a specific procurement of a complex product or for research and development involves technical determinations, assistance from government technical personnel should normally be solicited when evaluating proposed engineering staff-hour estimates. An understanding of the various fields of engineering specialists is important when fashioning requests for technical specialist assistance. The major engineering fields (i.e., industrial, mechanical, electrical, chemical, and civil) and several subspecialties are discussed in Appendix D.

a. Design Engineering. Data accumulated in the contractor's accounting system or adjunct statistical records which may be helpful in evaluating estimates

for design engineering include (1) the total number of basic design hours expended on previous contracts of similar complexity, (2) the number of various types of drawings required, and the average number of hours expended per type of drawing for prior contracts of varying degrees of complexity, (3) the percentage factors for support engineering (the direct engineering effort other than that expended by detailed designers working in the design department), and (4) percentage factors for engineering effort incidental to changes made during production which represent refinements of the product to attain improved performance.

b. **Production Engineering.** Production engineering generally represents engineering effort expended during the life of a contract, beginning with the completion of the initial design. Initial design is usually segregated from other engineering effort in the contractor's accounting or statistical records. Design changes for which costs are not segregated may occur during the life of the contract. In evaluating the reasonableness of production engineering estimates, review the contractor's methods and supporting data. Include a review of similar type engineering hours expended on previously completed projects of like complexity.

c. **Analytical Techniques.** The plotting of engineering hours of contracts of similar complexity, by month, will generally indicate the extent of design and production engineering effort related to significant points of contract performance. Graphic analysis may also indicate definite patterns of engineering contract costs compared to deliveries. When the estimate involves a follow-on procurement, or the run-out portion of an existing contract, using graphic analysis of prior experience is of particular importance in evaluating proposed engineering costs. The analysis should provide:

(1) An appraisal of the reasonableness of the monthly production engineering hours estimated by the contractor.

(2) A determination whether there is a marked reduction in engineering hours after the initial delivery.

(3) An appraisal, at an interim point, of the reasonableness of the contractor's estimated production engineering hours

for the run-out portion of contracts subject to price redetermination or for setting successive targets under incentive type contracts.

9-605.2 Special Tooling and Special Test Equipment

a. Special tooling is designed (1) to reduce the requirements for production/manufacturing labor hours and costs, (2) to speed production, and (3) to improve techniques, tolerances, and finished parts. The term includes jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment used in the production of end items. The term does not include general-purpose tools, capital equipment, expendable tools, small hand tools, tools acquired prior to the contract, replacement tools, and items of tooling which are usable for the production of items not required under the contract. The April 1984 clause referred to in paragraph c. below does not include as special tooling any item acquired by the contractor before the effective date of the contract, or replacement of such items.

b. Special test equipment means either single or multipurpose integrated test units engineered, designed, fabricated, or modified to accomplish special-purpose testing in the performance of the contract. Testing units comprise electrical, electronic, hydraulic, pneumatic, mechanical, or other items or assemblies of equipment, that are mechanically, electrically, or electronically interconnected to become a new functional entity. This causes the individual item or items to become interdependent and essential in the performance of special-purpose testing in the development or production of particular supplies or services. The term special testing equipment does not include: (1) material; (2) special tooling; (3) buildings and nonseverable structures (except foundations and similar improvements necessary for the installation of special test equipment); and (4) plant equipment items used for general plant testing purposes.

c. Contract clauses covering special tooling and special test equipment are provided at FAR 52.245-17 and 52.245-18 respectively. By memoranda dated 16

October 1990, 16 October 1991, 9 October 1992, and 14 October 1993 the Director of Defense Procurement (DDP) approved one year class deviations from the FAR 45.306-5 requirement to use the Special Tooling clause at FAR 52.245-17. The cumulative time period for these class deviations is 16 October 1990 through 16 October 1994 or until the FAR is changed, whichever occurs first. The DDP memoranda direct the use of the April 1984 edition of the Special Tooling clause in place of the current clause. The portion of the Government Property clause at FAR 52.245-2 that subjects special tooling to the title provisions contained in the Special Tooling clause was also waived since the 1984 edition of the Special Tooling clause does not contain title provisions. Generally speaking, the April 1984 clause is less stringent than the current clause which includes specific requirements regarding title retention, risk of loss, warranty and modification of tooling.

d. Audit Considerations

(1) The contractor may support the total tooling cost estimate (including estimated tooling hour requirements) by a detailed listing of the type and quantity of each special tool required, with the related estimated purchase or fabrication cost. To evaluate their reasonableness, compare the estimates for a selected group of these tools with actual costs or actual hours expended for similar tools in previous production, appropriately adjusted. Adjustments may be necessary to reflect differences in the number of tooling hours because of increased or decreased complexity of the product or improvements in methods and techniques. Replacement and maintenance type tools recorded as indirect costs, and items of a capital nature which should be obtained under a facility contract, should be excluded from the list of special tools.

(2) For follow-on production orders, determine whether any of the production tools purchased or fabricated on prior contracts will be available for use on the proposed contract and whether the cost estimate has taken this into account.

(3) Also be alert to estimated amounts over \$1 million for production special tooling and production special test equip-

ment (PST/PSTE) when the contracting officer expects that future contracts will be awarded to the same contractor for the same or similar items. If future contracts are not expected, allow full estimate of the maximum amount under the instant contract. If future contracts are expected, DFARS 215.871 allows for estimation (and eventual payment) of at least 50 percent of the maximum amount on the instant contract and the establishment of an amortization schedule for payments on future contracts. The deferred cost of production special tooling and production special test equipment, however, should not be shifted or assigned to other programs by charging such costs to indirect cost pools. This requirement does not apply to:

- (a) Special test equipment used solely for final production acceptance test;
- (b) Contracts awarded as a result of sealed bidding;
- (c) Contracts where the price is based on established catalog or market prices of commercial items sold in substantial quantities to the general public; or
- (d) Contracts where the price is set by law or regulation

(4) The use of graphic analysis to reflect the relationship between tooling costs of projects of like complexity with related delivery schedules will assist in evaluating the reasonableness of tooling costs in the current estimate. This type of analysis should provide information similar to that discussed in 9-605.1c.

(5) Determine whether expensive tools are justified and whether a sufficient number of employees with required skills are available to use the tools properly.

(6) Establish whether proposed special test equipment is justified. It must meet the definition for such equipment, and current inventories of government- or contractor-owned special test equipment should be reviewed to determine whether the equipment is available (see 7-200).

(7) For guidance regarding the application of cost of money to PST/PSTE costs, see 8-414e.

c. Liaison with Government Engineering Personnel. Maintain liaison with available government engineering personnel familiar with the requirements of the proposed procurement and obtain

information on (1) the availability of government-owned tooling and special test equipment, (2) the propriety of the numbers and types of tooling and special test equipment provided for in the estimates in relation to the production requirements, (3) possible savings which may be accomplished through improved tooling, and (4) the overall reasonableness of the estimated costs for tooling and special test equipment proposed by the contractor (see Appendix D-200).

9-605.3 Packaging

a. Packaging specifications are usually included in the request for proposals. These mainly depend on whether the item packaged will be shipped to a point within the United States (domestic) or overseas. Domestic packaging usually does not require special treatment provided it meets generally accepted end item packaging methods. The related cost may be classified as either an indirect cost or an ODC as long as it complies with the proposed accounting system to be used in costing the contract and all applicable Cost Accounting Standards. Packaging for overseas shipment requires special treatment, and the applicable costs are generally classified as ODCs. The special treatment accorded overseas packaging, as prescribed by government specifications, requires that crating materials be of a better grade than those used for domestic crating; and the packages must pass a water and moisture proofing test. When packaging cost estimates are based on complex technical determinations and the dollar amount is significant, it usually is appropriate to request the assistance of a government packaging specialist (see Appendix D-205).

b. The reasonableness of the contractor's packaging cost estimate may be evaluated by comparing it with costs incurred for similar types and kinds of packaging. Graphic analysis (e.g., time series or scatter charts) showing the unit packaging material and labor costs for related items or the relationship of packaging cost to shop cost over an extended period, may be used to plot the experienced costs for further analysis. Statistical data usually available in the packaging department can be used for this

comparison. In addition, review information regarding instructions for packaging under various specifications, packaging standard hours arrived at by scientific means, and packaging bills of material if available. When experienced cost trends are plotted on charts for further study and analysis, ascertain whether (1) all nonrecurring costs have been eliminated, (2) the packaging specifications of the current proposal are comparable to those which generated the experienced costs, and (3) the contractor has considered the possible impact to packaging material and labor cost trends resulting from expected changed market conditions.

9-605.4 Travel and Subsistence

Travel and subsistence costs usually include the costs of transportation, lodging, meals, and incidental expenses incurred by personnel while in travel status. When included as ODCs, the estimate usually is based on the contemplated number of trips, places to be visited, length of stay, transportation costs, and estimated per diem allowance. Questionable estimates for this cost may arise from such errors as the following:

a. Per diem rates projected that exceed allowable per diem costs as specified in the Federal Travel Regulations (FTR) for the 48 contiguous states, and the Joint Travel Regulations (JTR) and Standardized Regulations for locations outside the 48 contiguous states and foreign areas (FAR 31.205-46(a) and P.L. 99-234) after they have been escalated for expected inflation. For example, to estimate 1989 per diem rates, the latest established FTR/JTR rates for meals and lodging should be increased/decreased by a factor that reflects the forecasted economic change from the current established rate expiration date to 1989.

b. Transportation rates projected in excess of lowest customary standard, coach, or equivalent air fare offered during normal business hours.

c. Projected transportation costs for personnel to be transferred computed by using other than proper departure points.

d. Mileage allowances projected in excess of actual needs.

e. Excessive projected trip costs to a government activity or subcontractor lo-

9-605.4e.

cation for engineering coordination because the required number of trips and/or length of stay has been overstated.

f. A comparison of the current estimate with experienced costs of prior procurements of a similar nature indicates that the current estimate is unreasonable.

9-605.5 Field Service

Contracts may contain provisions requiring contractor engineering personnel to service delivered equipment. The cost, usually referred to as field service expense, may be included in the contractor's estimate as a separately identifiable ODC, or as a part of indirect cost. Whichever method is used, it must comply with the accounting system to be used in costing the contract and all applicable cost accounting standards. The cost of installation, maintenance and repair, and the development of operating instructions may be identified in the contractor's records as Field Service Expense, Guarantee Expense, Warranty Expense, or Reserve for Guarantee. Establish whether the procurement under review provides for field service. An evaluation of the field service estimate should include (1) review and evaluation of the data in support of the estimate, (2) comparative cost analysis, including the use of graphic analysis where appropriate, (3) discussions with other government representatives regarding complex engineering determinations, and (4) evaluation of the degree of conformity to the policy stated in FAR 22.1006.

9-605.6 Royalties

The contractor's cost estimate may include provision for royalties as a separately identifiable ODC or as part of

indirect cost. Determine whether royalties are proper for inclusion in the price and whether the contract will include royalty reporting requirements and royalty escrow or recapture provisions (FAR 27.206-1). The nature of the contractor's cost support for this element should be evaluated and addressed in the report.

9-605.7 Preproduction and Start-up Costs

Contractor's proposals should identify preproduction, start-up, and other nonrecurring costs, including such elements as preproduction engineering, special tooling, special plant rearrangement, training programs, initial rework or spoilage, and pilot runs. These costs may be susceptible to verification by a review of detailed documentation. In some instances, an analysis of experience on prior contracts by means described in Appendix E will help to establish the reasonableness of costs proposed. Ascertain the proposed handling of such estimated costs. If the total costs are not to be charged to the contract under review, determine whether the contractor intends to absorb the residual costs or recover them on subsequent orders.

9-605.8 Recoupment on Government Investment in Nonrecurring Costs

DoD Directive 2140.2 provides implementing guidance for recoupment by the government of a fair share of its investment in nonrecurring costs related to commercial sales of U.S. products and technology. When the auditor finds the contractor has not complied with the requirements of the directive, the appropriate procedures in 5-203 should be followed.

9-700 Section 7 — Evaluating Indirect Cost Estimates**9-701 Introduction**

This section provides guidance in evaluating estimates of indirect costs. These include manufacturing expense, engineering expense, tooling expense, material handling expense, selling expense, and general and administrative expense. Guidelines are also provided for evaluating indirect cost rates used in estimating indirect costs.

9-702 General

The evaluation of indirect costs and rates requires that the auditor have (1) an understanding of the applicable evaluation considerations and techniques, (2) an insight as to what reasonably may be expected to occur in future operations of the contractor and the probable influence on projected indirect costs and overhead rates, and (3) knowledge of the contractor's disclosed accounting policies particularly those for distinguishing direct costs from indirect costs (see CAS 402) and the basis for allocating indirect costs to contracts. (See Chapter 8.)

9-702.1 Evaluation Considerations and Techniques

a. The audit considerations in evaluating estimated indirect costs are similar to those used in the audit of historical costs because many estimates are based on historical costs. Audit guidance and procedures applicable to the review of indirect costs and the evaluation of contractor's policies, procedures, and internal controls which affect indirect costs are presented in 6-600. The effect of findings and recommendations developed through operations audits should be applied to estimated or proposed indirect costs and overhead rates (see 9-308b). Audit leads noted during the course of the review should be documented for follow-up in future operations audits of those indirect cost areas where it appears the contractor is not employing the most effective, efficient, or economical operations.

b. The auditor should consider the use of graphic analyses and statistical techniques in evaluating estimated indirect costs. Techniques of graphic analyses are discussed in Appendix E. These techniques alone do not provide a basis for firm forecasts of costs; however, in appropriate circumstances, they can provide a basis for ascertaining whether estimated costs are within a cost range of what can reasonably be expected in the future.

9-702.2 Anticipated Future Operations

Evaluation of indirect cost estimates requires consideration of anticipated future operations of a contractor (see 5-500 on review of budgets). To determine what may be reasonably expected to occur, the auditor should utilize analyses and projections of historical cost patterns and related data. When audits of historical costs are not reasonably current, and other methods of satisfying the audit objective are not available, the report should be qualified using the guidance in 10-304.2. Other methods of satisfying the audit objectives include reliance on certified contractor overhead submissions, the work of internal or independent auditors, or CAS compliance reviews. It should not be assumed that historical cost patterns and the results of overhead audits for prior years will continue without change; the auditor must consider contemplated changes which may influence the projections. Examples of changes and possible effects are discussed in the following paragraphs:

a. A change in the accounting policies governing the treatment of certain indirect expenses. This may include reclassifications of expense from direct to indirect, and new methods of accumulating and allocating indirect cost. Changes of this nature may affect the estimates for indirect costs and the computation of indirect cost rates. The auditor should be alert for accounting changes which would require the contractor to revise its Disclosure Statement (see 8-303).

b. A change in management objectives as a result of economic conditions and

increased competition. For example, the management may have placed emphasis, in the past, on a program to increase sales, whereas it now emphasizes a program to reduce costs. The auditor should ascertain the programs that management is stressing and determine that possible results have been considered.

c. A change in manufacturing processes and practices. Changing manufacturing operations can affect the flow of cost. Modernization changes may affect estimates for indirect cost and the computation of indirect cost rates. For example, technological modernization can include acquisition of expensive new machinery which increases depreciation costs and the overhead pool. This new machinery may require fewer labor hours and result in reduction of a direct labor base for allocating overhead. The auditor should be alert for changes to manufacturing processes and practices which can highlight accounting system weaknesses (14-800) and should consider whether:

(1) The accounting system accurately assigns costs to products and equitably allocates costs.

(2) The accounting system allocates costs to develop future product technology to existing products which receive no benefit.

(3) The accounting system reflects savings resulting from technological improvements.

(4) The accounting system integrates relevant data collected by newly implemented information systems.

9-702.3 Classification of Cost as Direct or Indirect

The auditor must determine whether cost items are directly or indirectly allocable to the proposed contract and that the estimated costs have been properly classified as direct or indirect. The auditor's review of the allocability of cost items should disclose any deviations from the contractor's usual direct and indirect cost classification. When deviations are disclosed, the auditor should determine the reasons for the differing treatment. Deviations may cause inequitable distribution of costs or they may be proper and warranted. The principles underlying the accounting and estimating

classification for direct and indirect costs should be sufficiently flexible to reflect changes in operations. CAS 402-"Consistency in Allocating Costs Incurred for the Same Purpose" was established to insure that each type of cost is allocated only once and on only one basis to any contract or other cost objective (see 8-402).

9-703 Evaluation of Indirect Costs

9-703.1 General

The scope and extent of the auditor's review of estimated indirect costs will depend on individual circumstances. As a minimum, the auditor should determine (1) the extent to which underlying data in support of the estimates are valid, current, and applicable to the proposal under review, (2) that the contractor has considered factors and conditions which have a bearing on the propriety of the estimated costs and the related allocation bases, including operations auditing recommendations for increased efficiency and economy, and (3) that the results are mathematically correct.

9-703.2 Classification of Indirect Costs

There are two general considerations in classifying indirect costs:

a. A determination that the cost is assigned to the correct indirect cost pool; for example, manufacturing, engineering, material handling, occupancy, or general and administrative. The auditor should review the composition of indirect cost pools to determine whether the accounts included are properly classified and whether further refinement in cost categories is required, and

b. A determination that indirect costs have been properly classified by characteristics; that is, variable, semivariable, and nonvariable. Variable costs will vary directly and proportionately with its related volume base. Semivariable costs may vary directly but less than proportionately, with volume; further, the costs may remain relatively fixed between certain production limits and advance by steps, an example of this is supervisory wages. Nonvariable costs, on the other hand, will remain fairly constant, but the percentage relationship will vary inverse-

ly with an increase or decrease in the related volume base.

9-703.3 Advance Agreements

The auditor should determine whether the contractor has entered into advance agreements with the government. Advance agreements may limit recovery of certain indirect costs such as independent research and development expense, bid and proposal expense, and recruiting expense.

a. When advance agreements cover indirect costs included in the estimates, the auditor should determine that allocations to government contracts are within the agreed limitations.

b. FAR/DFARS 31.205-18 no longer require advance agreements for IR&D and B&P costs for CFYs that began after September 30, 1992. However, for larger contractors that incur substantial IR&D and B&P cost (see 7-1505 for threshold information) certain ceiling limitations apply for the three CFYs ending after 30 September 1992.

c. Advance agreements covering forward pricing indirect cost rates may be entered into between contractors and contracting officers to reduce the time and effort required to evaluate the indirect cost rates used in each contract proposal. (See 9-1200 on forward pricing rate agreements). Circumstances on which the rates were developed may be subject to change or the contemplated procurement in itself may invalidate the propriety of the agreed upon rates. The auditor should not accept the rates without determining that they are reasonable and appropriate for the procurement being evaluated (9-312).

9-703.4 Allocation Bases

a. An equitable allocation of indirect costs to jobs, departments, processes, or cost centers is dependent upon the bases used. Bases commonly used include direct labor dollars, direct labor hours, production costs, input costs, and cost of sales. With the advent of technologically advanced manufacturing machinery, bases such as machine hours, process time, and operational movements will become more widely used (see 6-606.3c, 6-609.2e, and 9-702.2).

b. The evaluation of the bases used involves a determination of the accuracy of the data included in the base and equity of the resulting allocation. Because movement to an ACMS can encompass new types of allocation, the contractor may not be able to support the proposed base with accumulated historical data. The contractor may have to support the proposed base with a combination of documentation, such as production projections, historical data, employee interviews, manufacturer machine capability, and specifications and engineering analysis. Auditors should be open to verifiable forms of documentation which may be generated by the new system.

c. The auditor should review the FAO audit of mandatory annual audit requirement No. 18 related to indirect allocation bases (see 6-606). In evaluating allocation bases, the auditor should determine that the base estimates reflect valid trends. Trends may be evaluated through analysis of ratios, budgets, and sales and production volume forecasts. Anticipated changes, such as proposed increases or decreases in wage rates and material prices or implementation of modernized manufacturing processes and practices, should also be considered when such factors will influence the base. Further discussion of matters to be considered by the auditor in evaluating the contractor's estimate of future business is included in 5-507.2.

9-703.5 Individual Indirect Costs

The auditor should review selected accounts included in the indirect cost pools to evaluate the reliability of specific estimates. In evaluating projections, the auditor must consider historical cost patterns and the probable effect of anticipated changes. The auditor should review the FAO audit of mandatory annual audit requirements related to indirect cost comparison with prior years and budget (No.15), and indirect account analysis (No.16). In selecting accounts to be reviewed, the auditor should consider the following:

a. Indirect costs questioned in prior periods, especially those expressly unallowable, that are required to be eliminated by CAS 405,

b. Indirect costs of a nonrecurring nature,

c. Indirect costs that are usually recovered as direct charges or in separate loading factors, such as packaging or obsolescence,

d. Indirect costs which show significant differences between historical cost and estimated cost,

e. Indirect costs of a semi-variable or variable nature which do not show significant differences between historical cost and estimated cost despite a significant change in volume, and

f. Indirect cost of a nonvariable nature which show significant variations between historical cost and the proposed estimated cost.

9-703.6 Indirect Labor

Indirect labor usually represents a substantial portion of indirect costs. The auditor should review the FAO audit of mandatory annual audit requirement related to changes in direct/indirect charging (No.7). In evaluating indirect labor, the auditor should analyze variable, semi-variable, and nonvariable classifications of indirect labor in a current representative period. The ratios of each category to direct labor should be computed and compared with similar ratios for estimated cost. Projections of indirect labor requirements and the related costs can also be compared with manpower budgets. Indirect labor wage rates may be verified by reviewing personnel or payroll records. When projected costs include wage increases, the auditor should ascertain whether the proposed increases have been approved by management and are in accordance with applicable agreements.

9-703.7 Indirect Material

It is desirable to differentiate the treatment of the nonvariable, semi-variable, and variable components of indirect material cost contained in the contractor's projection. Ratios of these expense classifications to appropriate bases should be computed only when practical. To further facilitate evaluation, similar ratios can be computed from historical cost data. Categorizing the recorded indirect materials into these classifications re-

quires that the auditor exercise judgment in determining whether the additional evaluation effort needed for this type of analysis is warranted. For instance, when the contemplated procurement is not large in dollar amount, it is probable that treatment of indirect material expense as variable with the level of production activity would be expedient. Comparisons may be made of estimated requirements with budget requirements or estimated prices with current prices. When the proposed contract is a fixed-price incentive type with successive targets, or a fixed-price contract with prospective price redetermination and the contractor expenses the cost of indirect materials at the time of purchase, the auditor should recommend the establishment and maintenance of indirect material inventories. Implementation of this recommendation would preclude the loading of indirect material costs during the experienced or retroactive portion of the contract.

9-703.8 Payroll Costs—Taxes and Fringe Benefits

After establishing the estimated total direct and indirect labor requirements, the auditor should evaluate related payroll costs. The provisions of union wage agreements and the possible effect of anticipated wage negotiations should be reviewed to establish the validity of employee benefit costs included in the cost estimate. The auditor should be aware in evaluating the estimate for payroll taxes that assessments cease upon reaching the taxable pay ceiling. The extent of labor turnover will influence the projections for payroll tax estimates; when turnover is low, the cost will be semi-variable in nature, when the turnover is high, the cost may be more variable in nature. The auditor should review rates for unemployment insurance to determine if the estimate reflects possible adjustments in the rate. Pension and retirement plan costs frequently are related to payroll costs. In evaluating the reasonableness of pension and retirement costs, the auditor should (1) determine that the amount projected is in accordance with the company plan, (2) ascertain that the pension plan has been approved by the Internal Revenue Service, and by the Department

of Defense, if required, (3) determine that proper adjustment has been made for any reversionary credits that may be due, and (4) determine that when rates are based upon actuarial data and have recently been revised or are scheduled to be revised, the effect of the new rates has been considered.

9-703.9 Plant Rearrangement

Plant rearrangement costs may result from the introduction of new products, consolidation or expansion of departments, changes in production requirements, or changes in manufacturing techniques. In reviewing the detail supporting the projection of plant re-arrangement cost, the auditor should determine that like costs which will be reimbursable as direct costs under other contracts have been excluded from the estimate. Plant rearrangement costs applicable to a specific contract or project are normally not included in an indirect cost pool; plant rearrangement costs beneficial to all production effort are generally included in indirect costs. The guidance in Chapter 8 on CAS 402 should be applied to insure that plant rearrangement costs incurred for the same purpose are allocated only once and only on one basis. The auditor should review the plant rearrangement cost pattern in prior periods and compare actual costs incurred with previous estimates in evaluating the reliability of the current estimate. The auditor should be alert to costs categorized by the contractor as plant rearrangement but where the circumstances would indicate that they should more properly be included under the classification of "Plant Reconversion Costs." The definition and treatment of this latter category of costs are covered in FAR 31.205-31. The advice of government technical personnel should be solicited to establish the necessity and reasonableness of proposed significant rearrangement costs.

9-703.10 Depreciation

The auditor should be familiar with current Internal Revenue guidelines and CAS 404 (Capitalization) and 409 (Depreciation). The contractor's forecasts for depreciation should be evaluated using Internal Revenue guidelines as recog-

nized by current DoD instructions and in such Cost Accounting Standards as CAS 404 and 409 where applicable. The auditor should evaluate the necessity for new acquisitions, review the contractor's capital replacement or acquisition policy and ascertain whether (1) acquisitions have been approved by management, (2) actual commitments have been made, and (3) proper consideration has been given to lead time, installation costs, and rearrangement expenses (see 7-400).

9-703.11 Rent

Estimated rentals of machinery and equipment should be compared with costs incurred for rentals. Rental agreements should be reviewed to ascertain expiration dates and renewal and purchase options. The auditor's attention is particularly directed to FAR 31.205-36 for guidance in determining the reasonableness and acceptability of rental costs (including the sale and leaseback of facilities). In this connection, special emphasis should be on evaluating the contractor's policies and practices where significant portions of the plant and facilities are acquired by renting in lieu of purchase.

9-703.12 Occupancy Cost

The auditor should evaluate the reasonableness of costs associated with the use and occupancy of the contractor's facilities. These costs include insurance, taxes, heat, light, guard services, and maintenance expense. The evaluation should include a review of insurance coverage, tax records, assessment notice, utility bills, security requirements, and a comparison of estimated costs with the historical pattern of expense.

9-703.13 Excess Facilities

The auditor should determine whether estimated expenses for depreciation, rent, and occupancy include costs generated by excess facilities. When it is determined that costs attributable to excess facilities are included in the estimate, the auditor should be guided by FAR 31.205-17 and the provisions of the proposed contract. The auditor should consider any trends which might indicate the probability that excess facilities will develop during the period of the contract. A

review of the contractor's budgets should provide insight in this area (see 5-500). Factors which may create excess facilities include reduced workload, acquisition of additional facilities, and shutdown of existing facilities. When the auditor's evaluation indicates the probability of a significant increase in costs of excess facilities which will be allocated to the proposed contract, the auditor should recommend that the contract contain appropriate dollar limitations.

9-703.14 Corporate or Home Office Assessments

Indirect cost forecasts made by an operating division will usually include the anticipated home office assessment to that division. The reasonableness of the assessment should be evaluated on the basis of services to be rendered or available to the operating division. The bases of assessment should be reviewed to determine that all components of the company bear an equitable share. An accurate determination at the operating level may prove difficult and may include prorations of nonallowable home office and corporate expenses. When the amounts involved are significant, an assist audit of the home office expenses should be requested. The auditor at the operating unit should furnish the assist auditor with sufficient data as to the contemplated level of activity of the operating unit during the proposed contract period to enable the home office auditor to render an opinion as to the appropriate participation of the operating unit in the total allocable home office expense. When feasible, the home office auditor should arrange for the periodic review of forward pricing home office rates applicable to operating divisions which have significant amount of government business. The results of the reviews should be forwarded to the auditors at the operating units for their use in evaluating proposals (see 6-804).

9-703.15 Miscellaneous Income and Credit Adjustments

The auditor is concerned with credit adjustments to indirect accounts, credits to direct accounts which should have been credited to indirect accounts, and

miscellaneous income which has not been credited either to indirect or direct accounts.

He or she must consider whether the amount is correct, whether the period in which the adjustment or income is credited is appropriate, and whether the accounting treatment is acceptable.

a. As a minimum the audit should include a review of the contractor's financial statements, including the statements of cash flow, miscellaneous income accounts, and journal vouchers. The auditor should analyze the trends of the credit items in the periods covered by the estimate.

b. The auditor may find that the indirect expense pools have not been reduced by the amount of income received from such sources as scrap sales and rentals. Cash discounts taken and trade discounts may have been credited to income accounts.

c. Credit adjustments should be reflected in the indirect cost pools for amounts chargeable directly to contracts and amounts chargeable directly to termination proposals. The auditor should review the anticipated activity for contracts for technical services, overhaul, spare parts, and facilities, the costs of which are wholly or partially recovered either directly or on a fixed rate basis.

d. Credit adjustments should be applied against the expense originally charged; however, when the application of the credit would distort the expense projection, the credit should be shown separately as a reduction of the total indirect cost pool. Examples of such credit adjustment are worker's compensation insurance refunds, price adjustments on material purchases, and insurance payments under casualty claims.

9-703.16 Independent Research and Development and Bid and Proposal Costs

FAR 31.205-18 sets forth certain rules and procedures for establishing the allowability of IR&D and B&P costs. For contractors' CFYs beginning after 30 September 1992, the ceiling limitations have been removed for most contractors (see 7-1506). However, as discussed in 7-1506, ceiling limitations are still in place for three full CFYs after 30 September

1992 for larger contractors with substantial amounts of IR&D and B&P costs. After this time frame the limitation will be removed. IR&D and B&P costs forecast for these contractors should consider these limitations until they are removed. For those contractors where ceiling limitations are no longer applicable, the forecast of IR&D and B&P costs still need to be allowable, allocable, and reasonable and be of potential interest to DoD (see 7-1500).

9-704 Evaluation of Prospective Indirect Cost Rates

9-704.1 Evaluation of Rate

Indirect costs, while expressed as dollars, are calculated by the application of a rate to a selected cost base. To properly evaluate the acceptability and reasonableness of the contractor's indirect cost rates, the auditor should review the period covered by the rate and the propriety of the rate structure by which indirect costs are allocated to cost objectives.

9-704.2 Rate Period

a. The auditor should determine whether the period used in developing an indirect cost rate is appropriate for the contemplated period of contract performance. For example, if the rate used is based on projections covering a one year period and the period of contract performance is expected to cover two years, the rate may not be appropriate for the second year. When unable to support the use of such a single rate, the contractor should be requested to submit rates for the subsequent periods involved. When the period used by the contractor coincides with the period of contract performance, the auditor should determine that consideration has been given to all work anticipated during the forecast period which might influence the indirect cost rate. In evaluating the reasonableness of costs contained in long range estimates, the auditor may be confronted with an unwillingness on the part of the contractor to submit supporting data or an inability to submit reliable data. When there is reason to believe the contractor has data that relates to an estimate but is

unwilling to submit it, the auditor should so notify the contracting officer and recommend that the contractor be required to make such data available (see also 1-500).

b. Long range projections may lack sufficient data on which to base a reliable estimate. When the estimates are not susceptible to a reasonable evaluation, the auditor should so inform the contracting officer and make appropriate recommendations. For example, the auditor might recommend that a proposed award be made on a flexible price basis in accordance with the provisions of FAR Part 16/DFARS Part 216, particularly when uncertainties in the long term indirect cost forecasts are combined with the possibility of contract changes and the indefinite nature of the particular government program.

c. CAS 406 "Cost Accounting Period" was established to provide criteria for selecting time periods to be used as cost accounting periods for contract cost estimating, accumulating, and reporting. The Standard will reduce effects of variations in the flow of costs within each cost accounting period (see 8-406).

9-704.3 Propriety of Rate Structure

The equity of the allocation of indirect cost is dependent upon an evaluation of the rate structure. Contractors may compute separate indirect cost rates for indirect costs such as manufacturing expense or engineering expense, and the bases used in the computation of indirect cost rates may vary. Contractors modifying their cost accounting systems to an advanced cost management system may adopt the use of multiple rates (see 6-606.2c and 6-608.1c). Contractors must use the same rate structure for estimating purposes as they do for historical costing purposes. When a contractor employs a different rate structure for cost estimates, the auditor should inquire whether a change in its accounting system is planned. If a change is planned, the contractor must submit a cost impact statement resulting from the change and agree to an adjustment as required by FAR 52.230-5 of the CAS administration clause (see 8-500). The auditor should review the change to determine if the

different method causes inequitable results and the validity of the cost impact statement. A change in method is not improper by itself. The auditor should recognize that the impact of current procurement, changes in production mix, modernization of manufacturing processes and practices (14-800), and other factors may necessitate the revision of an existing rate structure to provide equitable cost allocations. The criteria used in determining the propriety of the number and types of indirect cost rates appropriate under varying conditions and the propriety of the related proration bases are discussed in 6-600.

9-704.4 Ceiling Rates

Indirect cost rates may be subject to sharp fluctuations. In periods of declin-

ing workloads, for example, indirect cost rates tend to increase because nonvariable costs are spread over a smaller allocation base. In the case of a corporate reorganization or a realignment of management functions, additional costs may be incurred which may result in an increase in indirect cost rates. When the auditor's review indicates the possibility of a decline in workload, a change in management functions or any other factor which would result in significant fluctuations in the rates, the auditor should determine the effect on the rate computation. Where warranted, the auditor should recommend ceilings in the indirect cost rates to prevent the acceptance of an unreasonable amount of indirect costs in the negotiation of the contract price.

9-800 Section 8 — Economic Considerations in Price Proposals**9-801 Introduction**

This section provides guidance on the evaluation of proposed economic costs.

9-802 General

There are essentially two ways that contract prices can reflect the impact of inflation over the contract performance period.

a. In the most widely used method, the proposed contract price includes current estimates of wages and prices that are expected to be experienced during contract performance. The preferred bases for current estimates are forecasts of future wage and price indices prepared by qualified, professional economists. Their predictions are based on econometric computer models of the U.S. economy which consider a large number of factors that influence wages and prices. Accordingly, when evaluating proposals by this method, follow the guidance for using economic forecasts explained in DCAAP 7641.74, Use of Economic Indexes in Contract Audits.

b. Alternatively, the contract proposal may be priced without escalation and an economic price adjustment (EPA) clause may be proposed. This arrangement is appropriate when there is serious doubt about the stability of future market or labor conditions during an extended contract performance period. When such expectations are not included in the contract price, and they can be separately identified, they may be covered by an EPA clause.

c. Use of EPA clauses has increased, primarily because of potential inequities that fixed-price contracting can produce in periods of economic uncertainty. Such clauses are intended to protect both the government and the contractor from the effects of abnormal wage and/or price changes which could cause significant losses or windfall gains for reasons beyond the control of the contracting parties.

9-803 Types of EPA Clauses

FAR 16.203-1 specifies three basic types of EPA clauses:

a. The first provides for adjustments based on established prices. It is used where basic commodities and commercial items (i.e., steel, aluminum, brass, bronze, copper, and standard supplies) comprise a major portion of the contract work. Price adjustments are based on an increase or decrease from a specified level in published or established prices of either specific items or price levels of contract end items.

b. The second type provides for adjustments based on the contractor's experienced labor or material costs and is commonly referred to as the actual cost method. This type of clause is used when there is no major element of design engineering or development work involved and one or more identifiable labor or material cost factors are subject to change. Price adjustments are based on an increase or decrease in specified costs of labor or material actually experienced by the contractor during performance of the contract.

c. The third type is referred to as the cost index method. It is used when there will be an extended period of performance and the amount subject to adjustment is substantial. Although many variations can be developed, one approach is to select representative BLS labor and material indices and project them into the future. Price adjustments result only if the actual indices are outside a defined range about the projections.

9-804 Evaluation Techniques and Considerations

a. Techniques to evaluate proposed costs subject to EPA clauses are dependent on (1) the appropriate clause, (2) the contractor's accounting system, and (3) other factors relevant to the proposed acquisition. As appropriate, use evaluation techniques in the preceding sections of this chapter.

99-804.b.

b. The evaluation techniques used in the preaward audit of a proposed EPA clause should be selected to assure that (1) economic factors already contained in the original price proposal are not duplicated, (2) the base period of the clause is the same period used to establish the base price, (3) the contemplated clause is the most appropriate for the anticipated contract environment, (4) the contractor's accounting system is capable of identifying and segregating the specific economic costs subject to adjustment from those attributable to qualitative and/or quantitative changes, and (5) an adjustment will be made for only those economic changes beyond the control of the contractor.

9-805 Unsatisfactory Conditions

Auditor vigilance is necessary to preclude unsatisfactory conditions as envi-

sioned by 4-803. While the auditor should be involved in preaward economic decisions, it may not always be possible to do an audit evaluation before the contract is executed; such action may not be requested or time may not permit a review based on the auditor's initiative. At all times, but especially when this is the case, the auditor must be alert to possible contractor windfall profits or other excessive cost recoveries due to the operation of the EPA clause. When these conditions are detected the contracting officer should be advised. All remedies should be exhausted at the FAO and regional level. If the situation continues, however, and resolution by the FAO or the regional office seems improbable, the condition should be reported in accordance with 4-803.

9-900 Section 9 — Profit in Price Proposals**9-901 Introduction**

a. This section provides policy guidance as to the auditor's responsibilities related to profit or fee included in the contractor's price proposal.

b. FAR 15.900/DFARS Subpart 215.9 state the government and DoD policies and procedures for determining profit and fee objectives for negotiated contracts. It is in the government's interest and therefore the general policy of DoD and civilian agencies to offer contractors opportunities for financial rewards sufficient to stimulate efficient contractor performance, attract the best capabilities of qualified contractors, and maintain a viable industrial base.

9-902 Weighted Guidelines for DoD Profit Policy

a. The weighted guidelines method set forth in DFARS 215.971 is generally prescribed for use by contracting officers in computing the profit objective to be used in negotiating contracts with commercial organizations where cost analysis is performed (see 9-903 for other methods). Under this method, the contracting officer is required to perform the profit analysis necessary to develop a prenegotiation objective for each contract action. The weighted guidelines method expressly takes into account (1) the contractor's degree of performance risk in producing the goods or services purchased under the contract action, (2) the contract-type risk assumed by the contractor under varied contract and incentive arrangements, (3) the level of working capital needed for contract performance, and (4) the nature of the contractor's facilities capital to be employed.

b. Contractors are encouraged to present the details of proposed profit amounts in the weighted guidelines format. This would facilitate a more complete discussion of the individual factors which will determine the overall profit objective. The contracting officer is required to utilize the weighted guidelines method in establishing a profit objective

for each applicable negotiated contract and to document the files accordingly. This "initial" profit objective is, of course, subject to later discussion and revision as part of the overall price negotiated for the contract. In establishing a profit objective for a prospective contract award, the contracting officer is required to consider all pertinent information, including audit data, available prior to negotiation. It is not, however, intended that the profit objective be computed based on precise mathematical calculations particularly for sub-elements of the major profit factors.

9-903 Other Methods for Establishing DoD Profit Objectives

Other methods for establishing profit objectives may be used for the contract types set forth in DFARS 215.973. Generally, it is expected that such methods will ensure that the appropriate profit factors and the relative values of these factors are considered. In addition, DFARS 215.972 describes the modified weighted guidelines method for nonprofit organizations. The procedures for establishing fee provisions on cost-plus-award-fee contracts are described in DFARS 216.404-2 and 215.974. Note that they do not permit the use of the weighted guidelines method.

9-904 Civilian Agency Profit Policies and Procedures

Civilian agencies' profit policies and procedures are contained in FAR 15.900 and those agencies' FAR supplements to 15.900. These policies also provide for a structured approach to the profit objective to be used in negotiating contracts with commercial organizations where cost analysis is performed. NASA uses the structured approach which considers contractor effort in each cost category, cost risk, investment, performance, socioeconomic programs, and special situations. DOE uses weighted guidelines which consider sub-levels of the cost elements, contract risk, capital invest-

ment, independent research and development, special program participation, and other considerations. DOT uses weighted guideline methods for manufacturing contracts, research and development contracts, and services contracts. Risk percentage ranges are provided by contract type for each of the contract categories. GSA uses a structured approach which considers material acquisition, conversion direct labor, conversion related indirect costs, other costs, and general management. Other factors include contract cost risk, capital investment, cost control and other past accomplishments, Federal socioeconomic programs, and special situations and independent development.

9-905 Responsibilities

a. Contracting Officer. After evaluating the contractor's cost proposal and establishing negotiation objectives on cost, the contracting officer is responsible for using the weighted guidelines method under DFARS 215.971 to complete DD Form 1861, Contract Facilities Capital Cost of Money. The completion of this form is a prerequisite to the completion of DD Form 1547, Record of Weighted Guidelines Method Application. These two forms are shown in DFARS 253.303-1547 and 253.303-1861. Note also that the contracting officer may request completion of these forms through normal field pricing support procedures (9-103 and DFARS 215.805).

b. DCAA. The auditor is responsible for determining that the contractor's financial and cost data supporting the profit allowance is fairly stated, and preparing report comments on this determination in accordance with the guidance in 10-307.6. Examples of appropriate areas for comment are provided in the following paragraphs on specific profit factors. However, see 9-906.6 on limitations.

9-906 Audit Policy

In conjunction with the evaluation of the price proposal, examine the contractor's profit submission and books and records to develop comments on the major profit factors for inclusion in the

audit report. Direct comments toward assisting the contracting officer in developing a profit objective for the contract and conducting the profit negotiations with the contractor. When methods other than weighted guidelines are used for establishing profit objectives, develop comments similar to those required under contracts where weighted guidelines apply. A percentage computation should not be shown in the report nor should the contractor's requested profit percentage be related to questioned costs. Also note that it is not Agency policy to initiate completion of the profit form, DD Form 1547, although the auditor may assist in evaluating or completing this form if specifically called upon to do so by the contracting officer.

9-906.1 Contractor Performance Risk

This factor under DoD weighted guidelines addresses the contractor's risk in fulfilling contractual requirements through consideration of three broad categories (technical, management, and cost). The auditor may include comments on these categories to assist the contracting officer in determining whether the profit objective for each category should be set toward the lower or upper level of the established percentage range. Examples of areas for comment include: reliability of management and internal control systems, reliability of cost estimates and the contractor's cost estimating system, and cost reduction initiatives and cost control (see DFARS 215.971-2).

9-906.2 Contract-Type Risk

a. This profit factor under DoD weighted guidelines focuses on the degree of cost responsibility accepted by the contractor under varying contract structures and incentive arrangements. When appropriate, comment on the availability or extent of cost history, the length of the performance period, the extent of effort subcontracted, and the extent of any costs already incurred under an undefinitized contract action (see DFARS 215.971-3).

b. For fixed-price contracts with progress payment provisions, an adjustment to consider contractor working capital needs is to be calculated by the contract-

ing officer and added to the contract-type risk factor. With regard to this adjustment, comment on the accuracy of allowable costs, whether the costs properly exclude facilities capital cost of money (FCCM), and the accuracy of the deduction for progress payments (see DFARS 215.971-3(e)(3)).

9-906.3 Facilities Capital Employed

a. This profit factor under DoD weighted guidelines recognizes the contractor's facilities capital to be employed during contract performance. The amount of recognition is separated among asset categories in proportion to the potential for productivity. The asset categories are land, buildings, and equipment. The designated profit rate ranges are 0 percent for land, 10 to 20 percent for buildings, and 20 to 50 percent for equipment. Note that significant emphasis is placed on the investment in equipment. The auditor may comment on the accuracy and distribution of the facilities capital employed among the asset categories or on the extent of idle facilities (see DFARS 215.971-4).

b. An alternate set of lower ranges should be used by contracting officers to compute the facilities capital profit factor (1) in the event that a firm which is predominantly facilitized for manufacturing work receives a service or R&D contract and (2) in recognition that the method used to allocate FCCM can result in a disproportionate asset allocation to R&D and services effort. The alternate ranges are 0 percent for land, 0 to 10 percent for buildings, and 15 to 25 percent for equipment. The auditor may comment on the proportionality of the asset allocation.

c. No fee or profit will be allowed under a "facilities contract" (see FAR 45.302-2(-)) or for facilities purchased "for the account" of the government under any other type of contract (see FAR 45.302-3(c)).

9-906.4 Cost Interrelationships

Cost interrelationships that affect profit should be noted in the appendix on profit, 10-307.6, and in other sections of the audit report, as appropriate. Examples include:

a. In the contractor-performance and contract-type risk categories, profit is not assigned to G&A expenses, costs of facilities when purchased for the account of the government, contractor IR&D/B&P, and FCCM. As a result, contractors may consider changes to their accounting structures in order to maximize profits. For example, it could be to the contractor's benefit to shift marginal G&A expenses into overhead or, alternatively, to segregate the G&A pool costs into two portions (G&A as defined by CAS, and other expenses). The contractor could then propose profit on the other expenses not categorized as G&A.

b. Also be aware of the interrelationships between DoD's profit policy and compliance with DFARS 215.871 on production special tooling and production special test equipment (PST and PSTE). The contracting officer should include where appropriate a special provision in the solicitation and contract which addresses how facilities capital cost of money will be estimated, measured, and paid on the unamortized cost of PST or PSTE and the computing of profit or fee for PST and PSTE. When questioning cost proposed in excess of the payment limitations imposed by DFARS 215.871 (see 9-605.2), make appropriate disclosures on whether the contractor took into account the implication of these items in profit consideration and FCCM.

9-906.5 Offsets

Be alert to the alternate approaches to the weighted guidelines method and that offset policies apply to certain pricing actions. DFARS 215.971-3(c)(3), 215.972(d), and 215.973(b)(2) and 215.974(c) address specific types of offsets or exclusions in establishing a fee/profit objective. Concurrently, if the contractor does not elect to claim or propose FCCM, recommendations should be made to insert the clauses at FAR 52.215-30 and -31 into the contract, if not already incorporated in the solicitation.

9-906.6 Limitations

Establishment of an appropriate profit allowance is a crucial aspect of most

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contract negotiations. Except for the comments suggested above, which are intended to help the contracting officer by furnishing the information which he or she will usually wish to consider, the auditor will not initiate action in the

profit area except upon specific contracting officer request. In this event, the auditor's effort will be limited to furnishing the information or factual data requested.

9-1000 Section 10 — Review of Parametric Cost Estimates**9-1001 Introduction**

a. This section contains an overview and general guidance on reviewing cost-to-noncost estimating relationships, primarily in the context of contractor price proposals. This section also contains guidance on the use of estimating standards in price proposals. It supplements guidance provided in this chapter, referenced appendixes, and in 10-300 which is applicable to proposal audits regardless of the cost estimating methods used. More detailed guidance can be found in Appendix D-400, Cost Estimating Methods. This supplementary guidance contains criteria contractors should meet before submitting proposals based on parametric cost estimates.

9-1002 Parametric Cost Estimating Terminology**9-1002.1 Definition of Parametric Cost Estimating**

a. Parametric cost estimating ("parametrics") has been defined as a technique employing one or more cost estimating relationships (CERs) to estimate costs associated with the development, manufacture, or modification of an end item (See D-405b). A CER expresses a quantifiable correlation between certain system costs and other system variables either of a cost or technical nature. CERs are said to represent the use of one or more independent variables to predict or estimate a dependent variable (cost).

b. Parametrics encompasses even the simplest traditional arithmetic relationships among historical data such as simple factors or ratios used in estimating scrap costs. However, for audit purposes our guidance will limit special consideration of parametrics to more advanced or complex applications. These may involve extensive use of cost-to-noncost CERs, multiple independent variables related to a single cost effect, or independent variables defined in terms of weapon system performance or design characteristics rather than more discrete material requirements or production processes.

EDP data bases and/or computer modeling may be used in these types of parametric cost estimating systems.

c. Parametric estimating techniques may be used in conjunction with any of the following estimating methods:

(1) Detailed — also known as the bottoms-up approach. This method divides proposals into their smallest component tasks and are normally supported by detailed bills of material.

(2) Comparative — develops proposed costs using like items produced in the past as a baseline. Allowances are made for product dissimilarities and changes in such things as complexity, scale, design, and materials.

(3) Judgmental — subjective method of estimating costs using estimates of prior experience, judgment, memory, informal notes, and other data. It is typically used during the research and development phase when drawings have not yet been developed.

9-1002.2 Distinction Between Cost and Noncost Independent Variables

a. Although the basic criteria for cost-to-cost and cost-to-noncost CERs are generally comparable, the supplementary criteria in this section pertain to cost-to-noncost CERs. Audits of traditional cost-to-cost estimating rates and factors are covered in other sections of this chapter and in referenced appendixes.

b. Cost-to-noncost CERs are CERs which use something other than cost or labor hours as the independent variable. Examples of noncost independent variables include end-item weight, performance requirements, density of electronic packaging, number or complexity of engineering drawings, production rates or constraints, and number of tools produced or retooled. CERs involving such variables, when significant, require that the accuracy and currency of the noncost variable data be audited. Special audit considerations are described in 9-1003 and 9-1004.

9-1002.3 Uses of Parametric Cost Estimates

a. Parametric cost estimating is used by both contractors and government in plan-

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ning, budgeting, and executing the acquisition process. Parametric cost models are generally made up of several CERs and can be used to estimate the costs for part of a proposal or the entire proposal. The cost models are often computerized and may be made up of both cost-to-cost and cost-to-noncost interrelated CERs. The guidance contained in this chapter is intended to assist in the review of parametric estimates, CERs, and/or cost models used in developing price proposals for negotiation of government contracts.

b. Parametric cost estimates are often used to crosscheck the reasonableness of estimates developed using other estimating methods. Generally, it would not be prudent to rely on parametric techniques based on a broad range of data points to estimate costs when directly applicable program or contract specific historical cost data is available, as in the case of follow-on production for the same hardware in the same plant. Nor would parametric techniques be appropriate for contract pricing of specific elements such as labor and indirect cost rates which require separate forecasting considerations such as time and place of contract performance. The use of a parametric estimating method is considered appropriate, for example, when the program is at the engineering concept stage and the program definition is unclear, or when no bill of materials exists. In such cases, the audit evaluation should determine that:

(1) the parametric cost model was based on historical cost data and/or was calibrated to that data, and

(2) the contractor has demonstrated that the CER or cost model actually reflects or replicates that data to a reasonable degree of accuracy.

9-1003 Parametric Estimating Criteria for Price Proposals

When a contractor uses parametric cost estimating techniques in a price proposal, the auditor will apply all pertinent criteria applicable to any proposal along with the supplemental criteria provided in 9-1004.

9-1003.1 Disclosure of Parametric Estimating Data

a. The purpose of the Truth in Negotiations Act, 10 U.S.C. 2306(a), is to provide the government with all facts available to the contractor at the time of certification and that the cost or pricing data was current, complete, and accurate (see 14-100). Parametric estimates must meet the same basic disclosure requirements under the act as detailed estimates.

b. Although the principles are no different, proposals supported in whole or in part with parametric estimating will present new fact situations concerning cost or pricing data which is required to be submitted. A fundamental part of the definition of cost or pricing data is "all facts . . . which prudent buyers and sellers would reasonably expect to have a significant effect on price negotiations" (FAR 15.801). Reasonable parallels may be drawn between the data examples provided in FAR for discrete estimating approaches and the type of data pertinent to parametric estimating approaches. For example, if a contractor uses a cost-to-noncost CER in developing an estimate, the data for the CER should be current, accurate, and complete (see D-406f).

c. Many contractors use parametric cost estimating for supplementary support or for crosschecking estimates developed using other methods. Judgment is necessary in selecting the data to be used in developing the total cost estimate relied upon for the price proposal. In distinguishing between fact and judgment, FAR states the certificate of cost or pricing data "does not make representations as to the accuracy of the contractor's judgment on the estimated portion of future costs or projections. It does, however, apply to the data upon which the contractor's judgment is based" (FAR 15.804-4[b]). Therefore, if a contractor develops a proposal using both parametric data and discrete estimates, it would be prudent to disclose all pertinent facts to avoid later questions about full disclosure (see D-406f).

d. The auditor should address the following questions during the evaluation of parametric cost estimates:

- Do the procedures clearly establish guidelines for when parametric techniques would be appropriate?
- Are there guidelines for the consistent application of estimating techniques?
- Is there proper identification of sources of data and the estimating methods and rationale used in developing cost estimates?
- Do the procedures ensure that relevant personnel have sufficient training, experience, and guidance to perform estimating tasks in accordance with the contractor's established procedures?
- Is there an internal review of and accountability for the adequacy of the estimating system, including the comparison of projected results to actual results and an analysis of any differences?

9-1004 Supplemental Estimating Criteria

The auditor should also consider the following supplemental criteria when evaluating parametric cost estimates.

9-1004.1 Logical Relationships

The contractor should demonstrate that the cost-to-noncost estimating relationships used are the most logical. A contractor should consider all reasonably logical estimating alternatives and not limit the analysis to the first apparent set of variables. When a contractor's analysis discloses multiple alternatives that appear logical, statistical testing (9-1003.3) of selected logical relationships may be used to provide the basis for choosing the best alternative.

9-1004.2 Verifiable Data

The contractor should demonstrate that data used for parametric cost estimating relationships can be verified. In many instances the auditor will not have previously evaluated the accuracy of non-cost data used in parametric estimates. For monitoring and documenting non-cost variables, contractors may have to modify existing information systems or develop new ones. Information that is adequate for day-to-day management needs may not be reliable enough for contract pricing. Data used in parametric

estimates must be accurately and consistently available over a period of time and easily traced to or reconciled with source documentation.

9-1004.3 Statistical Validity

The contractor should demonstrate that a significant statistical relationship exists among the variables used in a parametric cost estimating relationship. There are several statistical methods such as regression analysis that can be used to validate a cost estimating relationship; however, no single uniform test can be specified. Statistical testing may vary depending on an overall risk assessment and the unique nature of a contractor's parametric data base and the related estimating system. Proposal documentation should describe the statistical analysis performed and include the contractor's explanation of the CER's statistical validity. See Appendix E for information on techniques which may be used in the evaluation of the cost estimating relationships.

9-1004.4 Cost Prediction Results

The contractor should demonstrate that the parametric cost estimating relationships used can predict costs with a reasonable degree of accuracy. As with the use of any estimating relationship derived from prior history, it is essential in the use of parametric CERs for the contractor to document that work being estimated is comparable to the prior work from which the parametric data base was developed.

9-1004.5 System Monitoring

The contractor should ensure that cost-to-noncost parametric rates are periodically monitored in the same manner as cost-to-cost rates and factors. If a CER is validated and will only be used in a onetime major new pricing application, rate monitoring capability is not essential (see 9-1004.2). However, if it is expected that the rates should be considered as an ongoing estimating technique, CER monitoring is critical. The contractor should revalidate any CER whenever system monitoring discloses that the relationship has changed.

9-1005**9-1005 Areas for Special Consideration in Parametric Cost Estimating****9-1005.1 Parametric Estimating for Change Orders**

Change order pricing using parametric cost estimating relationships may need to be considered in a different light than initial contract pricing actions. The contractor may use cost estimating relationships which are unique to change order proposals. In general, contractors do not segregate costs separately for individual change orders. Therefore, it is important that the contractor have a system in place to validate, verify, and monitor CERs unique to change orders. However, if the CER was applicable to the basic contract and change orders, the CER could be validated without cost segregation.

9-1005.2 Forward Pricing Rate Agreements

a. Contractors may submit proposals for forward pricing rate agreements (FPRAs) or formula pricing agreements (FPAs) for parametric cost estimating relationships to reduce proposal documentation efforts and enhance government understanding and acceptance of the contractor's system. Government and contractor time can be saved by including the contractor's most commonly used CERs in FPRAs or FPAs. (See FAR 15.809 for basic criteria.) However, such an agreement is not a substitute for contractor compliance at the time of submitting a specific price proposal. FAR requires that the contractor describe any FPRAs in each specific pricing proposal to which the rates apply and identify the latest cost or pricing data already submitted in accordance with the agreement. All data submitted in connection with the agreement is certified as being accurate, complete, and current at the time of agreement on price on each pricing action the rates are used on, not at the time of negotiation of the FPA or FPRA (FAR 15.809 [d]).

b. Key considerations in auditing FPRA/FPA proposals for parametric CERs follow:

(1) FPRAs/FPAs do not appear practicable for CERs that are intended for use on only one or few proposals.

(2) Comparability of the work being estimated to the parametric data base is critical. FPRA proposals for CERs must include documentation clearly describing circumstances when the rates should be used and the data used to estimate the rates must be clearly related to the circumstances.

(3) Validation of all the parametric criteria (9-1003) is especially important if a single CER or family of CERs is to be used repetitively on a large number of proposals.

9-1005.3 Subcontract Pricing Considerations

a. FAR 15.806-2(a) requires that when a contractor is required to submit certified cost or pricing data, the contractor will also submit to the government accurate, complete, and current cost or pricing data from prospective subcontractors in support of each subcontract cost estimate that is:

- (1) \$1,000,000 or more,
- (2) both more than \$100,000 and more than 10 percent of the prime contractor's proposed price, or
- (3) considered to be necessary to adequately price the prime contract.

Use of parametric CERs does not relieve a contractor of its responsibility to disclose planned subcontract procurements and the related subcontractor cost or pricing data.

b. When proposed material costs are based on parametric estimates, the contractor must demonstrate that the type of materials required for the proposal are the same as included in the CER data base. The auditor should perform audit procedures to determine if:

(1) materials included in the CER data base are not estimated separately in the proposal, and

(2) adjustments have been made to the CER data base for those items which were previously manufactured in-house and now are being purchased. If the CER data base has not been adjusted, the contractor should provide a detailed cost estimate for purchased materials.

c. The contractor should explain any major differences between parametric estimates of subcontract costs and the subcontractor's quoted price and to provide the rationale for using the parametric estimate instead of the quote.

d. Consistency in subcontract cost estimating must be maintained within the contractor's estimating system. Any significant deviations from normal practices in the proposal must be identified and justified by the contractor.

9-1005.4 Parametric Estimating Efficiency

a. A primary justification for using parametrics is reduced estimating and negotiation costs. Contractors should perform a cost-benefit analysis before implementing an elaborate parametric estimating model. Their analysis should show that implementation and monitoring costs do not outweigh the benefit of reduced estimating costs. In many instances, new reporting systems may have to be developed to provide reliable non-cost independent variables. In addition, the costs of CER validation and monitoring may be substantial.

b. When the contractor's cost-benefit analysis indicates that the parametric system implementation costs might outweigh the benefits of reduced estimating costs and/or increased estimating accuracy, the matter should be pursued for potential cost avoidance recommendations as discussed in 9-308.

9-1005.5 Data Base Adjustment Considerations

a. One basic criterion (9-1003.4) is that the parametric data base be comparable to work being estimated. However, a contractor may have to adapt a partially comparable data base to its cost history using a "calibration" factor. An example would be an adjustment to the data base to estimate the savings as a result of continuous improvement initiatives such as TQM. The utilization of complexity factors and/or adjustments to modify contractor developed in-house CERs is a valid technique. However, the use of such factors or adjustments should be fully documented and disclosed. In addition, this approach increases the contractor's

burden to document compliance with the other criteria.

b. If a contractor does not support the adjustment factors, the contracting officer should be promptly notified (see 9-1004.8). In addition, the auditor should determine if a qualified or adverse opinion is required (see 9-209). The audit report should disclose the costs associated with the unsupported factors.

9-1005.6 Contract Administration Interface

a. Upon receipt of a request to review a price proposal, the auditor will coordinate with the Plant Representative/ACO to make arrangements for any needed technical reviews of the proposal (see D-100). Because of the special nature of cost-to-noncost estimating relationships, and the possibility of limited cost history and added audit testing, complete coordination is especially important when parametric estimates are involved.

b. While the auditor will address special areas of concern as requested by the PCO and/or the Plant Representative/ACO, the audit scope will be established by the auditor in accordance with the auditing standards (see 9-103.3), unless the PCO only requests a review of part of a price proposal (see 9-207).

c. Auditors should not actively participate as fully voting team members in a contractor's parametric estimating system development. However, they should be available, on request, to explain applicable price proposal criteria and identify any prospective audit concerns to both government and contractor personnel. An example of such audit advice would be to identify operating reports or records that have not been previously used to forecast costs and would therefore require added contractor support and audit testing. Such advance coordination will help avoid unnecessary contractor system development costs.

9-1005.7 Reporting of Estimating Deficiencies

The immediate reporting to the Plant Representative/ACO required by 9-205 will include any significant deficiencies in parametric cost estimates used in preparing a proposal. These may include

incorrect, incomplete, or noncurrent data and use of inappropriate estimating techniques. When a proposal evaluation discloses estimating system deficiencies, a separate report entitled "Estimating System Deficiency Disclosed during Evaluation of Proposal No. XXX" will be issued immediately after the proposal audit report (see 9-310b).

9-1006 Estimating Standards

9-1006.1 Distinction Between Estimating Standards and Parametric Cost Estimating

a. In terms of historical evolution and sophistication, the terminology of estimating standards as covered in this paragraph might be viewed as falling between traditional cost-to-cost estimating rates and factors and the more advanced types of parametric estimating systems (see 9-1002). However, a contractor may elect to use any combination of these evaluating methods, perhaps in the same proposal.

b. Estimating standards are normally developed through the use of motion-time-measurement studies performed by industrial engineers. Parametrics, on the other hand, are developed by relating historical costs to one or more noncost drivers. While estimating standards usually represent cost-to-noncost relationships, they have traditionally been limited to narrower or more discrete elements of estimated cost than may be the case in more complex parametric CERs. Also, the logic of the estimating relationship and the appropriateness of the mathematics in estimating standards will usually be readily apparent.

c. Estimating standards will not necessarily require validation under the criteria for parametric cost estimating relationships contained in 9-1003. Especially when such standards (e.g., hours/pound, hours/drawing, hours/page) have been in place and accepted by government personnel, the evaluation guidance in this paragraph will likely be sufficient.

9-1006.2 Use of Estimating Standards

a. Estimating standards may be established by relating engineering and/or pro-

duction costs (effort, time, and/or materials) to specific characteristics of a product such as composition, weight, size, or duration. This approach is designed to save estimating effort and has been used frequently in estimating construction costs and costs of recurring job orders such as printing. Many contractors use the technique in shop-order budgeting and production control.

b. Estimating standards may be used to estimate the cost of a single material item required for the work, or the cost of a single labor operation; for example, welding electrodes per ton of structural steel, press operations time per page, or guard-service costs per week. More complex, composite standards may be used to estimate costs of groups of components or broader classes of labor operations.

c. Use of estimating standards may be appropriate in contract cost estimating situations when there is a close correlation between an amount of production cost and the related product or process characteristic. The data sets being correlated must have been measured in a uniform manner. The cost data used should be verifiable by reasonable means. The units of measure used for base characteristics should be uniform and readily identifiable; the quantity or value of a characteristic should be readily determinable. Standards may be derived from industry-wide statistics but should be relevant and verifiable to the experience of the particular contractor using them.

9-1006.3 Applicability to Price Proposals

Traditionally, estimating standards have been used to estimate costs in lump sums, often including supervision, indirect costs, and occasionally general and administrative expense. To comply with the SF 1411 and cost accounting standards, the contractor will normally have to factor the estimate to identify the costs by cost element or function. Alternatively, a proposed cost based on an estimating standard might qualify for submission as an "other" cost element if the cost can be tracked as such and is a relatively minor part of the total proposal.

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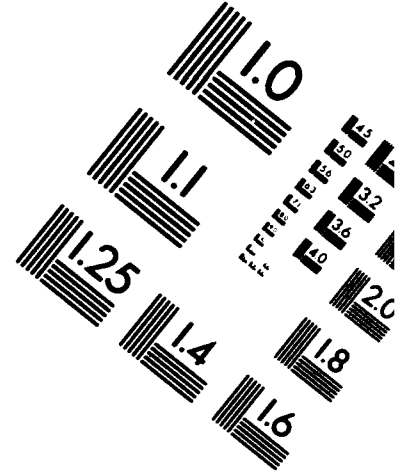
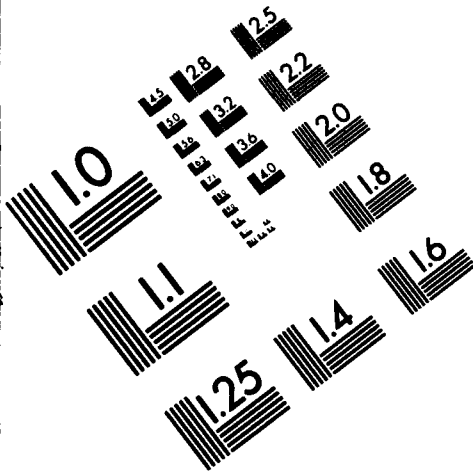
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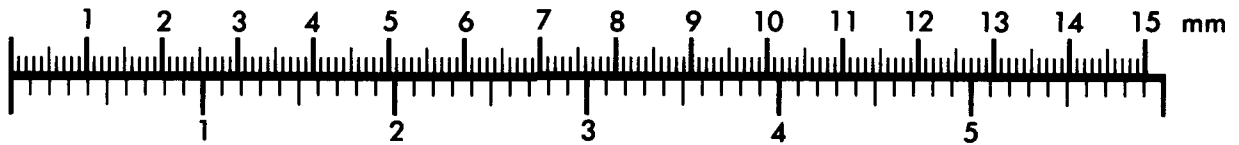
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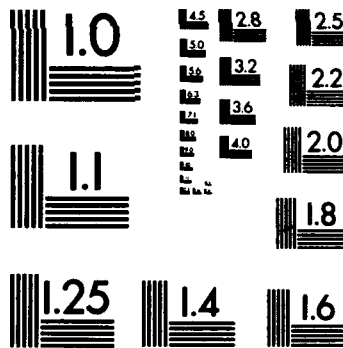
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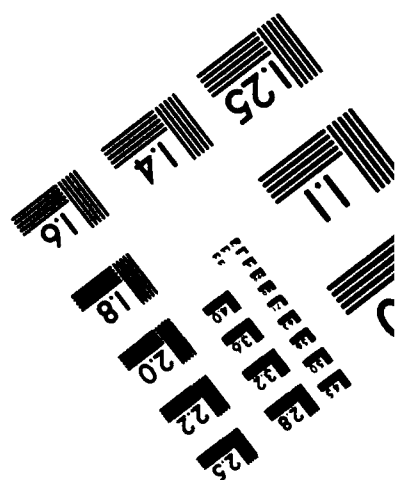
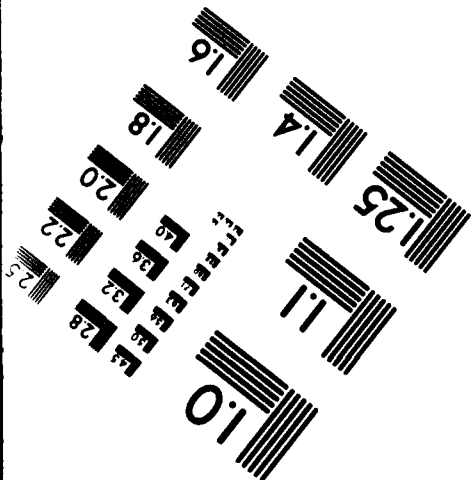
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9-1006.4 Audit Procedures

a. Depending on materiality and risk of the costs estimated, the auditor should examine the development and application of estimating standards to determine whether their use is proper in the circumstances. Evaluate all cost and noncost data applicable to each significant estimating standard and determine whether the data has been properly used in the computations. Assure that the measurements and correlation are adequate for the purpose (see 9-1005.2). Determine whether the basis for the standard (for example, the product mix, production rates, and production methods) is suffi-

ciently similar or comparable to that contemplated in the estimate at hand.

b. When changes are contemplated in the design or production of an end item or the rate or method of production, the contractor's adjustments of the estimating standards require special scrutiny. Review by government technical specialists may be necessary in this situation.

c. During audits of historical costs, sufficient information may be readily available from which the auditor could develop estimating standards to use as one means of appraising recurring contractor estimates. However, this will not substitute for audit review of cost estimates as submitted by the contractor.

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9-1200 Section 12 — Forward Pricing Rate Agreements**9-1201 Introduction**

a. It is DCAA policy that forward pricing rate agreements (FPRAs) between the government and contractors receive consistent audit treatment. In consonance with this policy, this section presents audit guidance covering the establishment and monitoring of FPRAs at contractor locations.

b. The guidance presented herein is intended to supplement the detailed guidance presented in other parts of CAM, such as 9-700, on the audit of estimated rates.

9-1202 Definitions and Background**9-1202.1 FPRA**

An FPRA, as defined in FAR 15.801, is a written agreement negotiated between a contractor and the government regarding certain rates and factors to be used during a specified period for pricing contracts or contract modifications. Such rates and factors represent reasonable projections of specific costs that are not easily estimated for, identified with, or generated by, a specific contract, contract end item, or task. These projections may include rates for labor, indirect costs, material obsolescence and usage, spare parts provisioning, and material handling.

9-1202.2 Forward Pricing Rate Recommendation (FPRR)

An FPRA, by definition, is a written agreement between the government and its contractor. A contractor, however, may not always be willing to enter into an FPRA because of frequently changing business conditions or other circumstances. If, under these circumstances, the government still wishes to use some form of preestablished pricing rates, forward pricing rate recommendations can be unilaterally established by the ACO. Although the establishment of an FPRR differs in some key respects from an FPRA, most of the audit guidance contained within this section applies equally to both types of rates.

9-1202.3 Forward Pricing Factor

A forward pricing factor is generally represented as a percentage or ratio that is applied to an existing cost or estimate in order to arrive at another, usually related, cost determination or estimate. Scrap, for example, is typically estimated as a percentage of unit material costs and then added to the unit material costs to develop total unit material costs. Other typical forward pricing factors include escalation, labor fringes, and special tooling.

9-1202.4 Formula Pricing Agreement

a. A formula pricing agreement (FPA) is a written agreement between a DoD contracting office and a large volume contractor which sets forth a methodology that the contractor agrees to follow when pricing items covered by the FPA. It differs from an FPRA in that, once established, the FPA may be used to determine the complete final price of individual orders. A typical FPA, for example, may be established to cover and expedite the acquisition of spares.

b. DCAA FAOs, as part of DoD's field pricing support team, are requested to review both contractor FPA and FPRA submissions. All FPA and FPRA submissions must be prepared and supported with cost or pricing data that is current, accurate, and complete. Contractor certification to this effect is required at the time agreement is reached on the formula price and/or at the time of agreement on individual orders over \$500,000 (see 9-1206). This difference aside, much of the audit guidance contained herein for FPRAs is also generally applicable to the review of an FPA.

9-1203 FPRA Initiation, Application, Use, and Expiration

a. The establishment of an FPRA may be initiated by either the contractor, PCO, or ACO whenever it is determined that the benefits to be derived from such an agreement are commensurate with the effort of establishing and monitoring it.

b. The government normally enters into an FPRA with contractors having a significant volume of pricing actions with the government. This avoids having to reestablish new rate estimates every time the contractor bids on new work. In determining whether to establish an FPRA, it is the ACO's responsibility to consider whether sufficient benefit can be derived from such an agreement.

c. Contracting officers will use FPRA rates as bases for pricing all contracts, modifications, and other contractual actions to be performed during the period covered by the agreement, unless the ACO determines that changed conditions have invalidated part or all of the agreement. Any conditions affecting the agreement's validity will be promptly brought to the ACO's attention.

d. FAR 15.809(c) requires an FPRA to include specific terms and conditions covering expiration, application, and data requirements for systematic monitoring to assure the validity of rates. The agreement must also provide for cancellation at the option of either party and require the contractor to submit to the ACO and to the cognizant contract auditor any significant change in cost or pricing data.

9-1204 Rate Identification and Support

Offerors are required in each price proposal to specifically describe the FPRA, if any, to which the rates apply and to identify the latest cost or pricing data already submitted in accordance with the agreement. (See FAR 15.809(d), FAR 15.804-4(g), and the instructions in FAR Table 15-2 for completing an SF 1411 and submitting a contract price proposal.) All data submitted in connection with the agreement, updated as necessary, form a part of the total data that the offeror certifies to be accurate, complete, and current at the time of agreement on price for an initial contract or for a contract modification (see Certification, 9-1207).

9-1205 Review Scope

a. The scope of an FPRA review needs to be tailored to the individual contract-

ing circumstances. At a minimum, however, the auditor should:

(1) Appropriately consider (i) the materiality of bases, pools, and rates; (ii) the results of prior DCAA reviews and adequacy of contractor internal controls; (iii) the historical differences between the contractor's forecasted and actual rates; (iv) changes in the contractor's organization, operations, manufacturing processes and practices (14-800), business volume, and allocation bases; (v) the mix of government and commercial business and types of government contracts; and (vi) Board of Directors minutes for documentation of any major decisions affecting the contractor's organization and operations.

(2) Determine that the contractor's (i) estimating practices comply with disclosed cost accounting practices; (ii) projected business volume, allocation bases, and indirect costs are reasonable and in consonance with the contractor's internal plans; (iii) rate data are valid and correct; and (iv) rate computations are mathematically correct.

b. The rates covered by an FPRA, although "preestablished" for periods of general use on more than one proposal, are audited in much the same manner as the forward pricing rates applied in the review of individual price proposals. Many of the steps for auditing forward pricing rate estimates are also similar to the steps for auditing historical costs and rates. Therefore, prior to determining the FPRA review scope, the auditor should become familiar with the CAM guidance covering the audit of both forward pricing rates (9-700 for indirect costs and 9-500 for direct labor) and historical cost rates (6-600 for indirect costs and 6-400 for direct labor).

9-1206 Evaluation

a. Budget Review Compatibility. Rate forecasting procedures are closely tied to the contractor's budgeting procedures. Therefore, auditors should review the budgeting procedures and related practices to (i) ascertain that, in the aggregate, the data upon which the judgments are made are sound and consider all available and relevant contractor data, and (ii)

determine whether the data supporting the proposed rates are compatible with company budgets and agree with the general conditions, standards, staffing factors, and other criteria used for planning and budgetary purposes. Further guidance on the review of contractor budgets and how it relates to an FPRA review is provided in 5-500.

b. Estimating System Reviews and Deficiencies. In evaluating an FPRA submission, the auditor should be familiar with (i) DCAA's guidance on estimating methods and system reviews in 9-309 and 5-1200, (ii) the details of the contractor's estimating system, and (iii) the disclosures from the latest DCAA or joint estimating system review. At a minimum, the auditor should perform a thorough review of the permanent file for outstanding estimating system deficiencies. Contractor estimating deficiencies disclosed as a result of system reviews or reviews of individual pricing actions can also apply to the contractor's FPRA estimates. Similarly, estimating deficiencies disclosed during an FPRA evaluation can also apply to the review of individual pricing actions. If an outstanding deficiency exists that has an impact on the FPRA evaluation or one is disclosed by the evaluation, then the auditor should adopt one of the reporting alternatives presented in 5-1212 and incorporate the deficiency accordingly into the FPRA evaluation report.

c. Comparison to Billing Rates. Because of the large degree of interdependence between billing rates and forward pricing rates for the current contractor fiscal year (CCFY), the auditor should expect both types of rates for the CCFY to be the same and to be covered by a Certificate of Indirect Costs. It is therefore important for the auditor reviewing an FPRA submission with CCFY rates to carefully compare these rates and supporting data with the most recent billing rates and supporting data for the CCFY. Any significant differences between the rates must be fully explained and supported by the contractor. If the auditor determines that billing rates should be revised, the contractor should be requested to submit a new billing rate proposal and the required certification. The con-

tractor must either submit the new proposal and certificate or, alternatively, certify the submission for the CCFY forward pricing rates. In the latter case, the CCFY forward pricing rate proposal also becomes the new billing rate proposal. If the contractor refuses to submit a more current billing rate proposal the procedures in 6-705 are applicable (also see 9-1207, 6-706.1, and DFARS 242.770 for further guidance).

d. Impact of Individual Pricing Actions

(1) Each pricing action needs to be initially evaluated to determine whether its impact upon the existing FPRA significantly changes the conditions upon which the FPRA was negotiated. FAR 15-809(e) requires that such changes be reported to the ACO. In assessing the changed conditions, the auditor should consider: (i) the type of contract contemplated, (ii) the dollar significance of the pricing action, (iii) whether the performance period of the proposed contract action is significantly different from the period to which the rate agreement applies, and (iv) any new data or other information that may raise a question as to the acceptability of the rates.

(2) The auditor should also be alert to any pricing action which does not accurately reflect the agreed-upon rates, incorporates the correct rates from an FPRA which has subsequently been declared invalid, or appears to seek preferential pricing rates (see FAR 15.809(e) and (f)/DFARS 215.809(e).

e. Allocation Methods and Activity Bases

(1) General. Even though a contractor has well-established and regularly accepted procedures for formulating and applying FPRAs, the auditor needs to periodically perform an in-depth analysis to determine whether these procedures and the proposed allocation methods and activity bases are still equitable. Guidance for making this determination is provided in 6-600, Chapter 8, and 9-700.

(2) CAS. The Cost Accounting Standards (Chapter 8) play a significant role in the development of rates and factors. Therefore, when evaluating an FPRA submission, the auditor should review the permanent file for any outstanding CAS problems relating to the rates, and

otherwise assess the current proposal for compliance with CAS.

(3) Rate Structure. Rate structure describes the number and types of rates established for a given set of conditions. It also determines how costs are to be allocated and the overall equity of the allocation. Contractors are required to use the same rate structure for forward pricing purposes as they do for historical costing purposes. Should a contractor employ a different structure for estimating its costs, the auditor needs to determine whether the contractor is changing its accounting system. If so, has the contractor submitted (1) a cost impact statement and (2) a revised disclosure statement as required by FAR 52.230-5 and 3 of the CAS administration clause (see 9-704.3 and 8-303.3).

(4) Rate Period. The auditor needs to determine that the rates used for forward pricing purposes are appropriate for the contemplated period of contract performance (see 9-704.2).

(a) Indirect Cost Rate Periods. The rate period for indirect cost rate estimates should generally coincide with the contractor's fiscal year period or the historical rate period established for the allocation of the indirect cost. Except for those situations explained in 8-406.1, an indirect cost rate period should not be computed for a period longer than one year. In certain circumstances, however, it may be more equitable for contract costing purposes to use a shorter indirect cost rate period than the contractor's normal fiscal year. These circumstances are explained in 6-605.

(b) Labor Rate and Factor Periods. The period for determining forward pricing factors and labor rates will also usually coincide with the contractor's fiscal year or historical rate period. The applicability of the period, however, must be examined for each pricing action. This is to determine whether the contemplated contractual requirements parallel the conditions that were contemplated in the development of the rates and factors, or whether conditions are present which indicate that the rate periods should be modified. The audit report should contain appropriate comments whenever the review of forward pricing rates and fac-

tors discloses that the estimated rate periods are unreasonable for the work to be performed. See 9-500 and 9-600 for further guidance, including the conditions under which forward pricing factors and labor rates should be modified.

(5) Forecasted Bases and Expenses. Auditors must use the knowledge and data that they obtain from reviews of contractors' budgeting and estimating systems as the basis for determining the validity of the contractor's estimates of base and expense pool amounts. In addition, the auditor should evaluate the information available from cognizant government acquisition and contract administration officials, as well as from outside sources. At a minimum, the auditor needs to verify that the forecasted allocation bases and estimated pool costs (i) are compatible with the contractor's current business volume estimates and developed in accordance with the latest management plans and (ii) appropriately consider the procurement requirements and limitations of the individual buying offices. (See 6-700 and 9-700 for further guidance on the evaluation of forecasted bases and expenses.)

f. Assist Audits. Corporate and other organizational allocations can have a substantial impact on forward pricing rates. Therefore, assist audit planning should be coordinated with the involved DCAA audit offices to ensure timely receipt of feeder reports. The planning should be geared to the contractor's budget cycle. Requests for assist audits of allocated costs or rates should not wait until the receipt of a contractor's FPRA proposal. (Also see 9-104.5(b).)

g. Use of Technical Specialist. The auditor should refer to the detailed procedures in Appendix D and throughout Chapter 9 for guidance (1) in making decisions about whether technical specialist assistance is needed, (2) identifying what type of technical specialist is needed, (3) deciding upon the best source for the technical assistance, (4) achieving good communications with the technical specialist, and (5) reporting on the uses of technical specialists or the impact of their nonavailability.

9-1207 Certification

a. Contractors seeking to enter into an FPRA are required by FAR 15.809(b) to provide the ACO with a proposal that includes cost or pricing data that are accurate, complete, and current as of the date of submission. No Certificate of Current Cost or Pricing Data is required, however, upon reaching a negotiated settlement on the FPRA (or other advanced agreement). This is because the rates in the FPRA are covered by the certificates that are executed when the individual contracts and contract modifications are negotiated. That is, when an FPRA or other advance agreement is used in partial support of a later contractual action that requires a certificate, the price proposal certificate shall cover (1) the data originally supplied to support the FPRA or other advance agreement and (2) all data required to update the price proposal to the time of agreement on contract price (see FAR 15.804-4(g)).

b. DFARS 242.770 requires contractors to execute a Certificate of Indirect Costs for the indirect rates, including the current contractor fiscal year (CCFY) rates, which form the basis for billings to the government (see 6-706). This Certificate is not required for the CCFY rates that have been prepared and submitted for an FPRA, unless the contractor and/or ACO maintain that the rates presented in the FPRA submission are also meant to establish the basis for the contractor's CCFY billing rates, and the contractor has not issued a certificate for the rates under a separate submission.

9-1208 Monitoring FPRA's

Primary responsibility for updating rates rests with the contractor, and ACO staff members often assume most of the government's responsibility for monitoring FPRA's. Notwithstanding this, the rates should also be reviewed periodically by the auditor to assure they are reasonably accurate. When appropriate, the auditor should:

a. Ensure that the rates are analyzed on a periodic basis by comparing the actual rates with the agreed-to rates. To avoid performing duplicate work, coordinate

with the contractor and ACO and determine if they are tracking and analyzing rates. If the contractor is not tracking and analyzing rates, the auditor should recommend to the ACO that the contractor perform this effort as a condition of the FPRA.

b. Compare new outputs from the contractor's budgetary system against the contractor's actual expenditure patterns for the CFY and against the budgeted amounts initially provided to support the FPRA.

c. Inform the ACO of any significant variances disclosed from monitoring the FPRA rates. When unfavorable trends or patterns begin to surface, perform the audit steps necessary to verify the patterns, and report your findings to the ACO along with the recommendation that the contractor be requested to submit a revised FPRA proposal. If, on the basis of the facts at hand, the ACO does not agree that revised rates are warranted, inform the FAO Manager for possible elevation of the issue(s), and consider performing more detailed audit steps to further support your position. Also see 9-1209 on reporting.

9-1209 Reporting

a. The auditor has two reporting requirements with regard to FPRA's. The format in 10-300 for price proposal reports will be adapted and used to report the results of an audit of a contractor's FPRA proposal submission. Note that while the establishment of an FPRA can be initiated by either the contractor, PCO, or ACO, the ACO is responsible for (i) obtaining all new or updated submissions from the contractor (FAR 15.809(b)) and for (ii) processing the requests for DCAA audit when field pricing support is available (FAR 15.805-5).

b. The second reporting requirement involves the auditor's obligation to promptly report to the ACO any conditions which may affect the validity of an existing FPRA. Although verbal notification and discussion of the conditions may be initially appropriate in some circumstances, such notification should be followed up by a letter or report when the

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notification is expected to be pursued. If the ACO determines that the condition has invalidated the agreement, the ACO should provide notification of this fact to all interested parties and initiate revision of the agreement (see FAR 15.809(e)).

c. Should the FPRA review disclose a contractor estimating system deficiency which has not been previously reported, the auditor should use one of the alternatives presented in 5-1212 to report the deficiency and ensure that the deficiency is appropriately incorporated into the FPRA evaluation report.

9-1210 Auditor Involvement at Negotiations

FAR 15.809(b) requires the ACO to invite the cognizant contract auditor to participate in developing a government objective and to participate in the negotiations of the FPRA. Upon completing the negotiations, the ACO should prepare a price negotiation memorandum (PNM) and forward copies of the PNM and

FPRA to the cognizant auditor, as well as to all contracting offices that are known to be affected by the FPRA. See 15-400 for further guidance on auditor support at negotiations.

9-1211 Postaward Audits

Forward pricing rates reflect the contractor's best judgments of what future expenses will be. The cost or pricing data supporting these judgments must be accurate, complete, and current as certified by the contractor when individual contracts are negotiated (see Certification above). To support their certifications, contractors must ensure continual surveillance of the cost or pricing data supporting the FPRA rates. Whenever the auditor has an indication that forecasted rates should have been revised for significant changes to reflect more accurate, complete, or current cost or pricing data, pricing actions using the rates should be subject to a postaward audit. (See 14-100 for detailed guidance.)

9-1300 Section 13 — Should-Cost Team Reviews**9-1301 Introduction**

a. The Armed Services Pricing Manual (ASPM) and other sections of this DCAA Contract Audit Manual espouse the "should-cost" approach as preferable to a "will-cost" approach in cost analysis of every noncompetitive proposal. The should-cost approach has the advantage of determining if the contractor has taken into account the most efficient and economical methods, considering all circumstances, in developing its proposal. By contrast, a will-cost approach would imply accepting a contractor's current methods of cost incurrence, and possibly perpetuating any prior inefficient/un-economical costs into future contract prices.

b. Although the should-cost approach to cost analysis is appropriate for all contract pricing actions, this section is limited to guidance on contract auditor participation in the should-cost team reviews required for selected major procurements.

9-1302 Nature and Purpose of Should-Cost Team Reviews

a. A should-cost team review, as discussed in FAR 15.810/DFARS 215.810, is a method of contract pricing that employs an integrated team of government procurement, contract administration, contract audit, and engineering representatives to conduct a coordinated, in-depth cost analysis at the contractor's plant. The purposes are (1) to identify uneconomical or inefficient practices in the contractor's management and operations and to quantify the findings in terms of their impact on cost, and (2) to develop a realistic price objective which reflects reasonably achievable economies and efficiencies.

b. A should-cost team review represents a rigorous and detailed onsite proposal evaluation. It is a specialized approach to the establishment of a fair and reasonable price based on what a contract (normally a major production contract) should cost in the environment and un-

der the conditions predicted for contract performance.

9-1303 Criteria for Performing Should-Cost Reviews

The decision on whether to perform a should-cost analysis is made by the contracting officer. Considerations in making this decision are in FAR 15.810b. Further, DFARS 215.810(b)(i) states that should-cost analyses shall be performed prior to the award of definitive major systems contracts in excess of \$100 million when all of several conditions identified therein are met. Waiver of the should-cost requirement is made at a high level in accordance with Military Service procedures.

9-1304 Team Makeup and Responsibilities

a. The should-cost review team (see Figure 9-13-1) normally consists of a team leader, a deputy team leader, a DCAA representative, an operations and administration officer, and three subteams: technical, management, and pricing. The Military Department establishing the team review will usually assign its own personnel as chiefs of the management, technical, and pricing subteams. Each subteam is comprised of contract administration and/or procurement office personnel responsible for the performance of specific functions.

b. After considering the results of DCAA operations audits, the technical subteam is responsible for the review and evaluation of a contractor's engineering, production, inspection, testing, and quality assurance systems. The technical subteam can also be expected to evaluate the technical aspects of proposed direct labor hours and material requirements. The management subteam evaluates the contractor's overall management approach and organizational structure and their impact on the estimated costs and proposed price. The pricing subteam obtains government field pricing support on subcontractor and intracompany price pro-

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posals and/or cost estimates (see 9-104 and 9-105) and develops the government's negotiation position.

c. As illustrated in Figure 9-13-1, the DCAA representative participates in the should-cost team review in an independent advisory capacity reporting directly to the team leader. Technical direction during the review will be provided by the auditor's supervisor.

9-1305 Processing Requests for Team Participation

a. DCAA will be responsive to requests received from Military Department procurement offices for contract audit participation in should-cost team reviews. Requests may either be processed through DCAA Headquarters or received directly by FAOs. Requests on reviews established by the Army are covered by a memorandum of understanding which is consistent with the guidance contained in this section.

b. When notified of a pending should-cost team review, the FAO manager, in conjunction with the regional audit manager, will assign a DCAA representative to the team. Selection criteria will include technical expertise, ability to establish and coordinate responsibilities of assigned personnel, and communication skills.

9-1306 Reserved**9-1307 Role of the Assigned Contract Auditor**

The role of the assigned DCAA auditor in a should-cost team review is essentially the same as in a regular audit of price proposal, as covered in other sections of this chapter. Specific DCAA responsibilities and functions as part of these team reviews are highlighted below.

9-1307.1 DCAA Review of Contractor's Proposal

The contract auditor will perform a comprehensive audit of the contractor's proposal in accordance with other sections of this chapter. The auditor has primary responsibility to evaluate and report on all financial/cost aspects of a

contractor's proposal and to determine the scope of audit. This responsibility includes but is not limited to a review of the following:

a. Direct labor hours. (This aspect of the review includes application of improvement curves and may be accomplished in conjunction with efforts of the technical subteam.)

b. Direct labor rates.

c. Indirect cost rates.

d. Direct material pricing.

e. Labor and material usage factors (for example, labor standards realization and scrap).

f. Make-or-buy decisions.

g. Major subcontract costs (to include an evaluation of whether the prime contractor is properly discharging its responsibility for the review of subcontractor proposals).

h. Estimating methods and procedures.

i. Adequacy of the cost accounting system for the proposed contract.

9-1307.2 DCAA Coordination with Subteams

The contract auditor and members of the subteams may in some cases have related and overlapping responsibilities in some review areas. To avoid duplication, efforts of the auditor and the subteams should be carefully coordinated.

9-1307.3 Communication of Contract Audit Results

a. The contract auditor will promptly advise the should-cost review team leader of significant findings during the audit, and discuss interim findings fully with other team members as requested by the team leader or as needed to further coordinate the overall team effort.

b. Report on any operations audit performed during the should-cost review in accordance with 10-400.

c. Overall results of the contract audit work on the should-cost team review will be provided to the team leader through a formal audit report prepared in accordance with 10-300. The team leader and auditor should agree on an audit report due date at the start of the review. The due date must provide enough time for a complete review of the proposal and

auditor monetization of findings developed by the subteams.

9-1307.4 DCAA Assistance After Report Issuance

a. The contract auditor will provide contract audit assistance to the should-cost review team leader as needed after issuance of the audit report. An example of this type of effort is the review of contractor proposal revisions, consistent with FAR 15.805-5(h). The DCAA representative will not, however, develop recommended government "fallback" positions since inclusion of this type of recommendation in our audit reports or audit advice may compromise the Agency's independence and contravene the advisory nature of audit services. While necessary post-audit assistance may be extensive, it is not anticipated to be continuous in most cases.

b. The auditor will attend negotiation and other conferences if requested by the team leader or other procurement official. Since the responsibilities and functions of the auditor assigned in a should-cost team review are essentially the same as in a regular review of a price proposal, the auditor's attendance at negotiation conferences will be governed by 15-400. Normally, the auditor should attend only those portions of the negotiation conference impacted directly by the audit review.

9-1307.5 Establishing Appropriate Responsibilities and Functions

a. The DCAA representative should ensure that DCAA review efforts and other functions on the team are consistent with the responsibilities of the contract auditor as stated in the DCAA charter (1-1S1). Early coordination of team responsibilities should provide an operating guide and checklist for the procurement office, team leader, and individual team members to use in defining and performing assigned functions. After the initial planning meetings with the other should-cost team members, the FAO should provide written confirmation to the team leader of the responsibilities of DCAA during the should-cost review. In addition, the FAO should maintain close and effective coordination

with the team leader during the review to ensure DCAA responsibilities and the timing for accomplishing these responsibilities are properly communicated to those involved.

b. During planning meetings, ensure that the team leader has a clear understanding of DCAA's role. It should be made clear that DCAA will not abrogate its responsibilities for proposal review or perform extensive clerical or other non-audit tasks for the team.

c. If inappropriately proposed functional assignments cannot be promptly resolved with the team leader, or if another government agency intends to perform DCAA responsibilities, the FAO should immediately notify the regional office and Headquarters, Attn: OPD.

d. At the conclusion of providing the requested audit services, the FAO is expected to issue an audit report following the general guidance contained in 10-200.

9-1308 Use of DCAA Operations Audits by the Should-Cost Review Team

a. The assigned DCAA auditor will furnish the should-cost review team leader a listing of the FAO's recently completed operations audits and any related information requested. The team leader can use this information in determining the scope of the should-cost review and assigning specific responsibilities to the subteams.

b. Recommendations contained in DCAA operations audit reports which are not yet implemented by the contractor should be monetized by the auditor and included in the audit report to reflect the impact on the proposal under review. In this manner, the results of DCAA's reviews of the contractor's economy and efficiency will help the should-cost review team to estimate what the proposed contract should cost the government under efficient and economical conditions.

c. If the team leader decides that supplemental economy/efficiency reviews are required as part of the should-cost review in areas of DCAA interest, DCAA will be given the first opportunity to

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perform operations audits in those areas. The FAO should perform all such reviews unless the FAO and regional office are unable to secure necessary technical as-

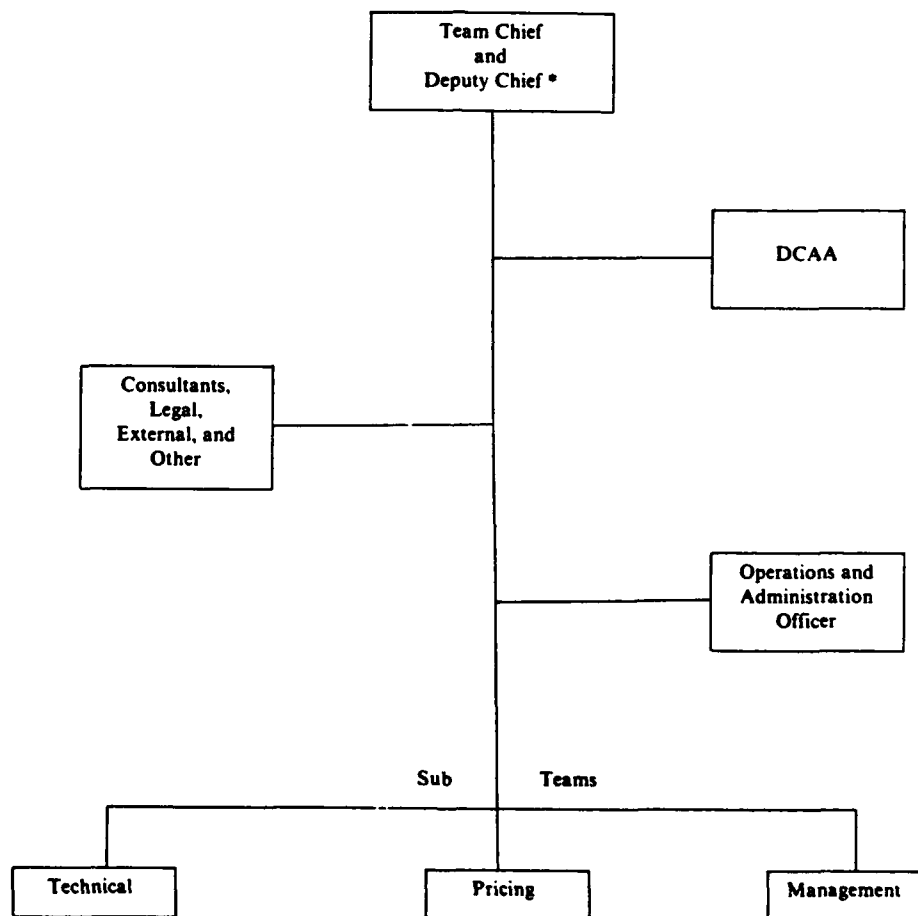
sistance, or cannot assign sufficient staffing to complete the reviews in time to meet the should-cost review schedule.

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Figure 9-13-1

Figure 9-13-1

SHOULD-COST REVIEW TEAM ORGANIZATION CHART



* PCO or designated Contract Specialist.

9-1400 Section 14 - Review of Proposals for Flexible Progress Payment Rates

9-1401 Introduction

This section provides guidance on the use of the DoD Cash Flow Computer Model (CASH) for computing customary flexible progress payment rates (DFARS 232.502-1-71).

9-1402 Background

a. Progress payments assist in financing a contractor's performance and reduce the contractor's investment in its work-in-process inventory. The actual investment in its work-in-process inventory is influenced by a number of factors in addition to progress payments, such as delivery schedules, cash management practices, and government payment practices. The DoD was concerned that the use of uniform, customary progress payment rates would result in inequitable variations in contractor cash flow requirements on individual contracts, depending on the aforementioned varying factors. Accordingly, a flexible progress payment procedure was designed and implemented to enable contracting officers to establish progress payment rates tailored more closely to the cash needs for financing performance of a particular contractor for a given contract.

b. For flexible progress payments, cash needs are measured and projected in relation to the contractor's and the government's investment in the work-in-process inventory over the life of the contract. Total investment is measured by a weighted average of total costs paid by the contractor to complete performance of the contract. The contractor's investment is the weighted average of the amount not paid by the government. The DoD, as a matter of policy, requires contractors to retain a minimum investment level in work-in-process inventory over the life of the contract. Accordingly, DoD will make progress payments at a rate that is the highest rate which yields a corresponding investment by the contractor in work-in-process inventory of not less than the contract specified minimum

investment percentage (MIP) (see Table 32-1 at DFARS 232.502-1-71(a)(7)).

9-1403 Contract Eligibility

Pursuant to Section 8155 of the FY 1994 Defense Appropriations Act (Public Law 103-139), the Director, Defense Procurement, issued an interim rule amending the Defense Federal Acquisition Regulation Supplement to preclude use of flexible progress payments on contracts resulting from solicitations issued on or after 11 November 1993. Contract modifications for in-scope effort (e.g., supplemental agreements, changes, exercised priced options, and definitization of letter contracts) will be financed at the rate established in the existing contract. Contract modifications that add new work to the contract shall be financed with the current customary uniform rate if the solicitation for that new work was issued on or after 11 November 1993. Separate progress payment requests are required for those contract modifications that are subject to the current customary uniform rate, when other parts of the contract are authorized financing using flexible progress payment rates.

9-1404 Timing and Scope of Audit

a. During periodic reviews of the contractor's progress payment requests, the flexible progress payment rate should be reviewed whenever there has been (1) a significant change in the float or lag factors, (2) a significant change in the delivery schedule, or (3) substantial work added to or deleted from the contract. If periodic reviews of the contractor's progress payment requests indicate a need to reassess the rate, audit support may be required relating to the redetermination of the flexible progress payment rate.

b. The ACO may request a review to determine if the computed investment percentage (CIP) in work-in-progress (WIP) continues to support the use of the current flexible progress rate. Table 32-1 (DFARS 232.502-1-71(a)(7)) contains the MIPs for each CASH model. The follow-

ing guidance pertains to the review of CIP.

(1) If the CIP has not changed by more than 2 points above or below the specified minimum, report that the contractor's CIP is within the investment tolerance for the CASH model specified in the contract, and the current flexible progress payment rate does not need to be changed.

(2) If the CIP is more than the 2 points above or below the specified minimum, perform a review of the flexible progress payment rate. In no event will the flexible progress payment rate be greater than 100 percent, or less than the uniform, customary rate that would have been applied to the contract absent flexible progress payments.

c. Audit scope depends on the nature of the audit request (e.g., rate reviews or float/lag reviews) and the auditor's professional judgment. Factors to consider when setting the scope include contract risk, familiarity with the contractor's operations, prior audit experience with the contractor, and the contractor's financial position.

9-1405 Contractor Submissions

a. Prior to negotiations (or renegotiation of an existing flexible rate, contractors should furnish cash flow data in the form and context specified for use in the DoD Cash Flow Computer Model. Required cash flow data includes: (1) actual and projected incurred cost by element of cost and by month for the duration of the contract, (2) float for each element of cost, (3) dates and lag of actual and projected progress payment and delivery payment receipts, (4) current contract price and (5) estimated profit percentage (DFARS 232.502-1-71(c)(1)). The data file submitted should be current and reconcilable to the actual contract price, actual and estimated cost records, and actual and estimated reimbursements.

b. The Flexible Progress Payment clause at DFARS 252.232-7003 provides for the reduction of the flexible progress payment rate plus payment of interest (DFARS 232.502-1-71(c)(3) and (4)) if the rate is later determined to be overstated because factual data submitted in

support of the computation was not current, accurate, and complete at the time the rate was established.

9-1406 DoD Cash Flow Computer Models and Guidance

a. The DoD Cash Flow Computer Model is a computer program developed to provide contracting officers with a means to determine flexible progress payment rates. This model takes into account key cash flow factors, such as contract cost profile, delivery schedules, subcontractor progress payments, liquidation rates, and payment and reimbursement cycles. Since inception of the flexible progress payment rate concept on 28 August 1981, there have been a number of changes to DoD's financing policies and the cash flow model.

b. The current DoD Cash Flow Computer Program, CASHP101 dated 26 September 1990, was issued by the Office of the Under Secretary of Defense for Acquisition; Director Defense Procurement; Office of Cost, Price, and Finance. CASHP101 is a PC-based computer program and is available to all auditors through DCAA's electronic Bulletin Board under file name CASHP.EXE. CASHP101 consolidates all previous cash models into one program; and will allow use of this program for future changes in progress payment policy. Rates applicable to each CASH model are contained in Table 32-1 of DFARS 232.502-1-71(a)(7). Program option 1 permits selection of CASH models II, III, IV, or V. Program option 2 requires user input and should be used only for those CASH models not covered by option 1 (i.e. CASH VI). Under option 2, the user must specify a particular uniform progress payment rate and MIP applicable to the contract. The prior cash models, the applicable uniform progress payment rates, and criteria for using these cash flow models are:

(1) CASHII: Used for contracts awarded prior to 1 May 1985. The uniform progress payment rate and MIP are 90 and 5 percent, respectively. Use program option 1.

(2) CASHIII: Used for contracts awarded between 1 May 1985 and 17

October 1986. The uniform progress payment rate and MIP are 80 and 15 percent, respectively. Use program option 1.

(3) CASHIV: Used for contracts awarded based on solicitations issued between 18 October 1986 and 30 September 1988. Since the fiscal year 1987 Defense Appropriation Act required contractors to retain at least a 25 percent investment in work-in-process inventory over the life of the contract, CASHIV is also used for contracts awarded after 30 September 1988 that were funded with government fiscal year 1987 appropriations. The uniform progress payment rate and MIP are 75 and 25 percent, respectively. Use program option 1.

(4) CASHV: Used for contracts awarded based on solicitations issued on or after 1 October 1988, not funded with fiscal year 1987 appropriations. The uniform progress payment rate and MIP are 80 and 20 percent, respectively. Use program option 1.

(5) CASHVI: Used for contracts awarded on or after 1 July 1991 through 11 November 1993. The uniform progress payment rate and MIP are 85 and 20 percent, respectively. Use program option 2.

c. Contracting officers were given discretionary authority on which uniform progress payment rate/Cash Model to use for certain contract actions in process as of the effective dates of the finance policy changes. As a result, there may be exceptions to the above time frames as well as several flexible progress payment rates and Cash Flow Models applicable to one contract. Refer to the contract clauses to determine the applicable progress payment rates and Cash Flow Models.

d. The DoD documents referenced in e. and f. below and the DCAA document referenced in 9-14081. are available to all auditors through the DCAA electronic Bulletin Board System under the self-extracting file CASHDOC.EXE.

e. Guidance concerning flexible progress payments is contained in the DoD Cash Flow Computer Model Users Guide, Revision 1, dated 1 February 1983. The guide was issued by the DoD Contract Finance Committee and was last updated in 1985. The guide provides illustrations of input and output, exam-

ples of float and lag computations, definitions of relevant terms, and is available on the DCAA Bulletin Board as multimate file U-GUIDE.DOC (see d. above). Input procedures for CASHP101 differ slightly from those in the model's Users Guide. Additional instructions accompany CASHP101 and are found in a file called README.DOC. The README.DOC file is in an ASCII format, not a MultiMate format.

f. Supplemental guidance to the DoD Cash Flow Computer Model Users Guide was provided by the Under Secretary Of Defense, Acquisition in two separate 1 July 1991 memorandums signed by the Director, Defense Procurement.

(1) DoD "Acquisition DP/CPF" memorandum includes guidance on progress payment lag time, material payment float, start up costs, cost statement date, and loss contracts. The document is available on the DCAA Bulletin Board as multimate file UPDATE-1.DOC (see d. above).

(2) DoD "Acquisition DP(DARS)" memorandum topics include customary progress payment rates and progress payment rate change implementation instructions. The document is available on the DCAA Bulletin Board as multimate file UPDATE-2.DOC (see d. above).

9-1407 Factors Influencing the CASH Model.

a. The most sensitive factors in the model are the progress payment and delivery payment lag times, and the float calculations. ACOs are encouraged to establish advance agreements at contractor locations for payment float and lag times which are common to several contracts (DFARS 232.502-1-71(c)(5)). From an audit standpoint, risk decreases as the contract approaches completion.

b. Progress Payment Lag. Progress payment lag is the length of time between the contractor's cost statement date (Block II of the SF1443) and receipt of the progress payment. Progress payment lag cannot exceed 56 days. Under normal circumstances, no more than 5 of the 56 days should be allowed for the contractor to prepare and submit a progress payment request. Since government risk increases

when lag factors are overstated, large proposed lag increases should be investigated. Although lag has the greatest influence on the CIP and payment rate, the exact impact of changes in the progress payment lag cannot be precisely determined due to the effects of all the other variables in the model.

c. **Delivery Payment Lag.** Delivery payment lag is the number of days between the acceptance date shown in Block 21 of the Material Inspection and Receiving Report, DD Form 250, and the receipt of the actual delivery payment. The delivery payment lag cannot exceed 60 days.

d. **Float.** Float is the number of days between the cost statement date and the time the cost is actually paid including bank lag days (the lag between the issuance of the check and payment of the check by the bank). For material payment float, the period begins with the date the contractor receives the material, records a liability and charges the cost to a contract and ends the day the payment is made by the bank. Float can be either positive or negative. Paid costs have a negative float and unpaid costs have a positive float. The float for unpaid cost cannot exceed 28 days. Float days have the same overall affect on the CIP as lag days; however, their influence is weighted by the percentage of the cost element with which they are associated. The auditor should be alert to proposed decreases in positive float or proposed increases to negative float.

e. **Other Factors.** Percent of cost paid, contract delivery schedule, and length of contract all have a lesser affect on CIP and progress payment rate. The percent of cost paid factor for any cost element is the ratio of the cost incurred and paid in a single cost statement period (ending on the date shown in Block II of the SF1443) to the total incurred and paid for that element during that same period. The longer the contract, the less sensitive are these factors.

9-1408 Other CASH Model Considerations.

The following is guidance for each of the pertinent CASH model input items:

a. **Start-up Cost.** Start-up cost is defined as precontract cost and includes only those costs that are properly allocable and allowable against a contract but incurred prior to the contract's start date (9-1408b.). Ensure that these costs have been properly authorized and approved by the government for progress payment purposes.

b. **Contract Start Date.** The contract start date entered on Line 1 of the CASHP101 data file represents the first day of the accounting period of the first cost statement whether that cost statement was subject to a flexible rate or not.

c. **Cost Statement Date.** The cost statement date is the date entered at Item 11 on the SF 1443. This is the cut off date for including costs on the progress payment request and it should correspond to the last day of the interim accounting period.

d. **Letter Contracts and Definitization.** Flexible progress payment rates are not permitted on undefinitized contract actions (DFARS 232.502-1-71(b)(2)). Upon definitization, the use of a flexible rate may be granted if all the requirements at DFARS 232.502-1-71 are met. If granted, all contract cost (actual and estimated) from the contract start date forward should be entered into the data file. Start-up cost should be entered as a lump sum on line 1 of the data file.

e. **Contract Options and Modification.** The contract data file should reflect current contract price information. For example, if the contract includes options and these options are exercised, the option prices can be added to the basic contract data file. Those contract modifications subject to different CASH models (or the customary uniform rate, see 9-1403) require separate accounting, separate data files, and separate progress payment requests. Flexible rates should not be recommended where separate data files are required but not maintained.

f. **Singular Contract/Multiple CASH Models.** Contract modifications can be subject to CASH models that are different from that covered by the basic contract. If subject to a different CASH model, separate progress payment requests and data files would be necessary. Flexible rates should not be recommend-

ed where separate data files are required but not maintained.

g. Loss Contracts.

(1) If the sum of the total costs incurred under a contract plus the estimated costs to complete exceed the contract price, the contracting officer shall compute a loss ratio factor and adjust future progress payments to exclude the element of loss (FAR 32.503-6(g)(1)). Loss contracts would not impact computation of the flexible progress payment rate; however, the costs eligible for progress payments would be adjusted downward by the loss percentage (see 14-205f).

(2) Loss position contracts that qualify for rate redeterminations must first have their data files altered through the use of a loss ratio because the official DoD CASH program cannot process actual unadjusted data for a contract in a loss position. For contracts in loss positions, the contract price (current ceiling price under fixed-price incentive contracts) should be revised (FAR 32.503-6(g)(1)) to include any pending change orders and unpriced orders to the extent funds for the orders have been obligated. The revised contract price is divided by the sum of the total costs incurred to date plus the estimated additional costs of completing contract performance to arrive at the loss ratio. All contract price revisions should be confirmed with the contracting officer before including them in the loss ratio computation. The contract data file should be adjusted to reflect the same price revisions and estimated costs used to compute the loss ratio. Apply the loss ratio (see FAR 32.503-6(g)) to the EAC (including start up cost) so that EAC as adjusted equals the contract price (current ceiling price under fixed-price incentive contracts) and profit equals zero. Loss ratios should be applied evenly to all cost elements within each cost statement (including start up cost) in the data file. After making the necessary adjustments, the data file as revised can be run through the appropriate CASH model. Progress payments subject to a new rate are also subject to the related loss ratio adjustment.

h. Liquidation Rates. The government recovers progress payments by reducing the payment (contract price) for contract

items delivered, accepted, and invoiced by the amount of previous progress payments. Actual deliveries in the data file represent those completed items and should contain the delivery date (DD250 block 21 date), the delivery value (DD250 block 20 amount), and the liquidation rate. Planned deliveries should contain delivery dates and delivery values only. The liquidation amount is based on the application of a liquidation rate (FAR 32.503-08 through -12) to the contract price of contract items delivered and accepted. The CASHP101 program calculates and provides the liquidation rates (ordinary and alternate) in the analytical report. Whenever the liquidation rate is changed, the contracting officer shall issue a contract modification (FAR 32.503-9(c)) to specify the new rate in the progress payment clause.

(1) The ordinary method (FAR 32.503-8) is that the liquidation rate is the same as the progress payment rate; at the beginning of a contract, only this method may be used.

(2) The alternate method (FAR 32.503-9 and -10) permits the contractor to retain the earned profit element of the contract price for completed items in the liquidation process. The minimum liquidation rate is the expected progress payments (i.e. contracting officer determined - usually the EAC times the progress payment rate) divided by the contract price (FAR 32.503-10(b)).

i. Overliquidation. The "Overliquidation of Progress Payments" error message is generated by the CASH model whenever the unliquidated progress payment balance is zero or negative. This condition usually occurs when: (i) a delivery is not in the proper sequence (i.e. too early for the amount of cost incurred), (ii) the "one-to-one" relationship (subject to minor exception) between cost statements and progress payments is not maintained, or (iii) actual progress payments were less than what the model would have calculated. The current official DoD CASHP101 model will not provide a flexible rate when overliquidation occurs. Since some versions may produce a flexible rate when overliquidation occurs, do not accept any rate accompanied by an "Overliquidation of Progress Payments" error

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message. Do not recommend any flexible rate without first running the data file through the official DoD Cash program (currently CASHP101).

j. FLEX and Subcontractors. DFARS 232.502-1-71(b)(4) covers the requirements imposed on contractors and subcontractors for subcontractor eligibility for flexible progress payments.

k. CASH Model Execution Questions. The intent of the flexible progress payment model is to reflect the contractor's anticipated and actual cash flow for each contract. It is the contractor's cash flow and resulting CIP in its work-in-process inventory that determines the progress payment rate. Unless all questions are properly answered, the contractor's cash flow, CIP in work-in-process inventory, and progress payment rate will not be properly computed. Therefore, if the data file submitted is not current, accurate, and complete, notify the contracting officer and return the submission to the contractor.

l. Editing/Converting FLEX data files. Contractors should be encouraged to sub-

mit their FLEX data files in ASCII format. The ASCII data files can be edited with the DOS editor or converted to MultiMate, edited, and reconverted for the CASHP101 program. Multimate document EDIT.DOC explains how to create or edit a data file in MultiMate and convert from/to ASCII for the CASH program. EDIT.DOC is one of four MultiMate files contained within the Bulletin Board System (BBS) self extracting file CASHDOC.EXE (see 9-1406d.).

9-1409 Reports

The audit report should be prepared and addressed to the contracting officer who requested the audit. If the review was initiated by the auditor, the report should be addressed to the government representative responsible for review of the contractor's requests for flexible progress payments. In all cases where he or she is not the addressee, the ACO should be furnished a copy of the report. The content of the report should conform to Chapter 10.

CHAPTER 10

NOTICE

During the finalization of this CAM update, the Agency adopted the new audit report format described in MRD 94-PFD-163, dated 26 September 1994. FAOs began using the new format 31 October 1994 and sample audit reports using the new guidance were added to the DCAA Bulletin Board under the file name NUFORMAT.ZIP.

At this printing, Chapter 10 is only partly revised to incorporate the new report format guidance (i.e., 10-400). During the transition, auditors should adapt the guidance in Chapter 10 to the reporting format in MRD 94-PFD-163 and the examples in NUFORMAT.ZIP.

Watch for cc:Mail announcements of updates to NUFORMAT.ZIP.

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CHAPTER 10

10-000 PREPARATION AND DISTRIBUTION OF AUDIT REPORTS

10-001 Scope of Chapter

This chapter discusses the importance of DCAA audit reports and provides guidance in preparing quality reports. It presents standard report formats and

describes the elements common to all audit reports. The chapter also includes specific instructions on format and content of audit reports for various types of major audit assignments.

10-100 Section 1 — Audit Report Quality

10-101 Introduction

a. This section emphasizes the importance of audit report quality and describes the characteristics of a quality audit report. It also includes a brief discussion of some important report writing techniques to assist auditors in preparing quality audit reports.

b. Written audit reports are to be submitted to the appropriate officials of the organizations requiring or arranging for the audits. Copies of the reports should be sent to other officials who may be responsible for taking action on audit findings and recommendations, and to others authorized to receive such reports.

c. The issuance of a report is not intended to limit or prevent discussions of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. Except for conclusions and recommendations to the contracting officer with respect to pricing proposals, such discussions are encouraged (see 4-300).

d. There are a number of reasons why written reports are necessary. In addition to their value in making the auditor's findings and recommendations less susceptible to misunderstanding, reports should be prepared in written form (1) so that the results can be communicated to responsible government procurement officials and occasionally to higher levels in the Department of Defense, (2) for use in negotiation proceedings, and (3) to facilitate follow-up to determine whether appropriate measures have been taken in response to the auditor's findings and recommendations.

10-102 Importance of Audit Report Quality

Reports of some kind are necessary in all occupations. The importance of the DCAA audit report cannot be overemphasized. Audit reports are the principal means of conveying our audit results to contracting officers and other interested parties. Because effective reporting is a major factor in building and maintaining confidence in DCAA audit activities, we must continually strive to produce high quality reports. Auditors must exercise due care in preparing, reviewing, and processing reports to provide reasonable assurance that reports contain no grammatical and mathematical errors, and no errors of fact, logic, or reasoning.

10-103 Characteristics of a Quality Audit Report

The DCAA audit report must satisfy government auditing standards as outlined in 2-400 and 2-600. A good report will present the scope and results of a quality audit in an objective, concise, complete, and easy to understand manner. Report findings and conclusions must be accurate and reasonable, not unfair or misleading, and supported by sufficient objective evidential matter. The report should also reflect common sense and good judgment in dealing with requester needs, materiality, and level of detail provided.

10-103.1 Timeliness of Reports

a. Reports are to be issued on or before the dates specified and, in any event, as

promptly as possible. To be useful, the audit report must be timely. The auditor should realize that every day of delay in issuing the report diminishes its value. Therefore, he or she should plan and conduct the work with the objective of reporting the results not later than the date the report is due.

b. The auditor should consider reporting significant matters to appropriate officials during the course of the audit work. Such reporting is not a substitute for a final written report, but it does alert officials to matters needing correction at an earlier date.

c. When a specified reporting date does not allow sufficient time to perform a complete audit (especially major proposals, sensitive reviews, or where there is potential for significant audit findings) the auditor should:

(1) Request a time extension detailing the areas where work will be incomplete because of the time restrictions.

(2) If the extension is not granted, issue a qualified report advising that audit effort is continuing.

(3) Alert the ACO and PCO of significant findings resulting from this continuing audit effort. Issue supplemental report(s) confirming these findings until it is clear that reporting the findings can have no further impact on the outcome of the negotiations.

d. When time limitations or weaknesses in supporting documentation make it impossible to submit a complete report and the audit work is not to be continued, the auditor should report within prescribed time limits whatever information is available, with appropriate comments as to the audit scope.

10-103.2 Report Content

The audit report should be easy to understand, present the scope of the audit and the auditor's findings and conclusions in an objective and complete manner with appropriate support for positions taken, and provide recommendations for improvement whenever appropriate.

a. Accuracy, Completeness, and Fairness. Report preparation, review, and processing procedures should be applied to produce reports that contain no

errors of fact, logic, or reasoning. The need for accuracy is based on the need to be fair and impartial in reporting and to assure readers that what is reported is reliable. One inaccuracy can cast doubt on the validity of an entire report and can divert attention from the substance of the report. Although reports should be concise, they should not be so concise that they do not fully inform the user. Reports should contain sufficient information about findings, conclusions, and recommendations to promote adequate understanding of the matters reported and to provide convincing, but fair, presentations in proper perspective. Sufficient amounts of background information should also be included. Readers should not be expected to possess all the facts that the auditor has. Therefore, reports should not be written on the basis that the bare recitals of facts make the conclusions obvious or inescapable. If the auditor has conclusions or opinions that he or she wishes to present, the auditor should state them specifically. Presenting valid findings in their true light is essential to the accuracy and the integrity of the report. These findings must be presented so they can be fully understood.

b. Objectivity. Findings should be presented in an objective and unbiased manner and should include enough information on the subject matter to give readers proper perspective. Reports should be fair and not misleading and, at the same time, emphasize matters needing attention. The auditor should guard against any tendency to exaggerate or overemphasize deficient performance noted during the review. The information needed to provide proper report balance and perspective should include: (1) appropriate information as to why the examination was made, (2) information about the size and nature of the activities or contract(s) to which findings relate, and (3) correct and fair descriptions of findings so as to avoid misinterpretation. Where statistical sampling or other quantitative methods are used, a comment to that effect should be made a part of the auditor's explanation of the individual cost elements involved. However, detailed procedural information should not

necessarily be given. See 4-605 for a discussion of sampling policy.

c. Adequate Support. All factual data, findings, and conclusions in reports should be supported by sufficient objective evidence to demonstrate or prove the bases for the matters reported and their accuracy or reasonableness. Except as necessary to make convincing presentations, detailed supporting data need not be included in reports. Opinions and conclusions in reports should be clearly identified as such and should be based on enough audit work to warrant them. In most cases, one example of a deficiency cannot support a broad conclusion and a related recommendation for corrective action. All that it supports is the finding of a deviation, error, or weakness. When appropriate, audit reports should refer to other audit reports pertaining to matters covered. For example, comments pertaining to the adequacy of the accounting system, purchasing practices, and indirect cost rates should be referenced to reports issued on these subjects.

d. Recommendations. The auditor's report should contain appropriate recommendations whenever the review discloses that the contractor's operations can be significantly improved. The auditor should also make recommendations to effect compliance with legal or regulatory requirements when significant instances of noncompliance are noted. If the auditor cannot make appropriate recommendations, he or she should state in the report why he or she is unable to do so and what additional work needs to be done to formulate recommendations. However, the audit report is only advisory and it should be understood by all parties that recommendations are not directives and there is no contractual requirement for the contractor to comply. It is for this reason that reports should be worded in a manner which will induce confidence in, and acceptance of, the audit findings and recommendations. Tactful, tempered, and factual reporting can achieve the objective of acceptance without diminishing the auditor's independence. Conversely, sharp, critical, and inflammatory expressions should be avoided because they create resentment and an atmosphere in which the auditor's

conclusions may be challenged. To ensure full and fair reporting, care and diligence should be exercised so that the audit report fully recognizes contractor difficulties, other pressing needs, and corrective action taken.

e. Issues Requiring Further Study. If the scope of the audit or other factors limit the auditor's ability to inquire into certain matters which he or she believes should be studied, report such matters and the reasons why they merit further study.

f. Recognition of Noteworthy Accomplishments. Information on satisfactory aspects, not just the deficient aspects, of operations examined, when significant and when warranted by the extent of the work, should be included in the auditor's report. Such information is often necessary to fairly present the situation which the auditor finds and to balance the report.

g. Views of Contractor Officials. Except for audit findings in pricing reports, one of the most effective ways of ensuring that reports are fair, complete, and objective is through advance reviews and comments by contractors. This produces a report which shows not only what was found and what the auditor thinks about it, but also what the contractor thinks about it and what, if anything, will be done about it. This kind of report is more useful to the recipient. Comments on report drafts should be objectively considered and evaluated, and the report should appropriately recognize them. When a contractor promises corrective action, it should be noted in proper context but should not be accepted as justification for dropping a significant point or a related recommendation. When the advance comments oppose the auditor's findings or conclusions and are not, in his or her opinion, meritorious, the auditor should state the reasons for rejecting them. Conversely, the auditor should drop a point or modify a position if he or she finds the contractor's argument meritorious.

h. Scope and Objectives. The scope of the audit should be stated in all reports. Some audits are more limited in scope than others; for example, those confined to specific functions, activities, or con-

tracts. Such limitations should be clearly and explicitly identified. When successive audits vary in scope, the auditor should explain why particular work was or was not performed and should also define the limited nature or special aspects considered in performing the audit. The time period of the audit should be specified. The audit report should also include a summary of the objectives of the audit. This statement is essential to give the reader a background against which any reported findings may be considered. The contracting officer may request special coverage; this, too, should be mentioned in the report. The auditor is expected to conduct the review according to the auditing standards in this manual. Normally, the report will state that the audit was performed on a selective basis, according to generally accepted government auditing standards, and that tests of appropriate records, managerial and other controls, and operations were made as necessary. When acceptable auditing procedures cannot be followed or have been limited by unavailable or inadequate records, time, or other reasons, the auditor should comment on the scope of the audit and qualify the report. The auditor's statement should not be burdened with unnecessary details. However, the areas evaluated by the auditor, the extent of the evaluation, and the firmness of the recommendations should be evident from the auditor's comments.

i. Omitted Information. If the auditor is prohibited from including some pertinent data in the report, he or she should describe what has been omitted and the restriction that makes the omission necessary.

10-103.3 Audit Opinion

a. Subject to specific reporting limitations, the report will express the auditor's opinion and recommendations, both on the cost representations or financial statements taken as a whole or, where appropriate, on individual elements. The report will also state whether the financial data have been prepared in accordance with the Federal Acquisition Regulation (FAR) and the related agency sup-

plement, if any, and Cost Accounting Standards (CAS), if applicable.

b. Material changes in accounting policies and procedures and their effect on the financial data are to be explained in the audit report. In addition, the report will comment on significant financial issues affecting the contractor's cost representations. Violations of legal or other regulatory requirements, including instances of noncompliance, will be explained in the audit report.

c. The contract auditor's work normally culminates in an expression of opinion on the acceptability of the contractor's cost representations or financial statements. However, cost representations or financial statements often reflect estimates, approximations, and matters of judgment or opinion, rather than absolute facts. While there are still acceptable alternative accounting methods, all falling within the concept of generally accepted accounting principles, there are governing regulations in CAS and FAR which limit the contractor's flexibility in presenting cost representations.

d. A contractor's cost representations may be prepared in accordance with its accounting system, may be based on statistical computations developed as part of the regular accounting system, or from adjunct statistical data; or the contractor may use a formula method for developing costs. The audit report should contain the auditor's opinion as to the acceptability of the methods used by the contractor. An explanation of the methods used should be provided if it is not otherwise evident.

e. The auditor should determine if any material changes have been made in the accounting practices utilized by the contractor. Material changes and the reasons for them should be identified, and their effect on the financial representations, both historical and prospective, should be explained. The auditor should also state his or her opinion as to the propriety of the change. When applicable, CAS places some specific limitations to the extent of such changes and requires submission of price adjustment proposals as a result of changes made to previously disclosed or established cost accounting practices.

f. Events that occur after the audit may have a material effect on government contract costs. Events such as potential contract overruns affect government contracts directly, while other events, such as impending financial instability, affect all government work. If such events occur before issuance of the audit report, they should be disclosed in the report. If an audit report has already been issued, the auditor should issue a supplemental report when the impact on government contract costs is significant.

g. The possibility that isolated errors of omission or commission will go undetected is always present. Therefore, the auditor cannot certify that all of the costs submitted by the contractor are correct. The auditor can only express a professional opinion as to the acceptability of the cost representations.

h. Before expressing an opinion, the auditor should have obtained and reviewed the available facts and performed, to the extent necessary, a searching and analytical review of the contractor's representations and supporting data. When necessary, the auditor should seek technical assistance from the contracting officer in those matters that fall within his or her purview in such areas as industrial engineering, production control, quality assurance, etc. The request should initially be verbally and then confirmed in writing. The auditor should refer to and give effect to the technical findings and opinions of others in the audit report; when appropriate he or she will attach the original copy of the technical report to the audit report. If the auditor cannot get the necessary technical assistance before completing the audit, he or she should qualify the opinion in the report and indicate the areas in which, and the extent to which, he or she believes a technical evaluation is necessary.

i. When a contractor's cost representation or financial report is sufficiently complete to permit an audit evaluation, but does not conform to requirements imposed by contracts, agreements, laws, regulations, or administrative procedures (for example, format, timeliness, or certifications), or when certificates or information required from government personnel have not been received, the audit

report should explain the deficiency, if known. The effect that the deficiency may have on the validity of the cost representation should be commented on when practicable.

j. A contractor's reports and statements, both financial and operational, should contain the information necessary to form an opinion on contract financial management aspects. The responsibility for providing such information rests with the contractor. However, the auditor should comment if the data provided are insufficient to disclose any matters which may have a material effect upon government contracts.

(1) Adequate disclosure does not imply or require that an excessive amount of information be furnished. Disclosure should, however, be fair and reasonably complete, but not so complex as to confuse or impede understanding. Information should be reduced to manageable and understandable proportions; yet, it should avoid summarization to such an extent that needed background or relationships are omitted or blurred.

(2) Weight should be given to materiality, which is the relative importance or relevance of an item included in or omitted from financial reports or contract cost statements. There are no universal ratios or percentages that can be used as standards of materiality for financial or operational processes or transactions. Materiality should be based on judgment. Six specific indicators of materiality which can be used individually or in combinations are: absolute dollar amount; ratio of amount of an item to an appropriate base figure; length of life of an asset; importance of the item to the accomplishment of the mission; importance to the maintenance of adequate controls (such as a pattern of small discrepancies); and the characteristics of the items involved (such as indications of malfeasance or misfeasance). The Cost Accounting Standards Board addressed the issue of materiality as it applies to CAS-covered contracts. No one criterion was considered necessarily determinative. The criteria are: absolute dollar amount; ratio of the amount of an item to an appropriate base figure; the relationship between a cost item and a cost

objective; the impact on government funding; the cumulative impact of individually immaterial items; and the cost of administrative processing of the price adjustment modification.

(3) Events that occur after the audit may have a material effect on the operations of the contractor or on its financial representations. Such events should be disclosed in a supplemental audit report (10-216).

k. When the contract auditor is expected to provide an opinion on the fairness of the presentations in contract financial statements, compliance with applicable laws and regulatory requirements is a matter of importance. Noncompliance might result in liabilities to the contractor. Compliance with laws and regulatory requirements, in many instances, assumes an even greater importance, since the recipients of the contract financial statements and the audit reports also want to know whether funds were spent for the designated purposes.

10-104 Good Writing Techniques for Effective Audit Reports

a. A very important aspect of performing a quality audit is communicating the results of that audit. Good field work and analysis are wasted if the audit report is not effective in communicating our audit conclusions. Our customer is interested in a clear and concise audit opinion, with supporting data that is easily understood.

b. Natural writing ability is not necessary for effective audit report writing. The task of writing effective audit reports does not require the creative writing skills of a novelist, for example. Rather, effective audit report writing first requires knowledge of good writing techniques, which can be acquired through training and practice—learning by doing.

c. Effective audit report writing also requires us to select efficient ways of collecting the information we need for the report, such as writing working paper purpose, scope, source, and conclusion paragraphs so that they can be effectively used to draft the report. This process involves keeping the needs of the reader in mind throughout the audit so that the audit addresses the relevant issues and

the auditor records the results in a format which can be readily used to prepare the report.

d. Here are some suggestions on techniques for effective writing. These can be reinforced with formal training. Using these kinds of techniques can aid you in improving the overall quality of your audit reports.

10-104.1 Planning the Audit Report

a. Planning to write the report begins with the receipt of a request for audit and/or establishment of the assignment. Planning continues throughout the audit process, from the development of the audit program to the completion of the working papers and then the report itself. For the report to be effective, the needs of the customer must be clearly understood and addressed in the report.

b. Anticipating early in the audit process what is required for the audit report will help ensure that the audit program is properly designed and all necessary information is obtained during the course of the audit. This includes writing working paper purpose, scope, source, and conclusion paragraphs which can be readily used to draft the report. This will save time.

c. These actions will result in efficiency and effectiveness, with improved audit report quality. Auditor and supervisory time will be saved in the report writing and review phases of the assignment. This will result in a properly documented work package, containing all of the evidence of a well-planned audit, which effectively supports the report.

d. Writing audit reports requires original writing combined with CAM recommended wording. Use the recommended paragraphs carefully and revise them to suit your audit situation.

10-104.2 Organizing the Audit Report

a. Much of the required structure for the organization of an audit report is prescribed in other parts of Chapter 10. You should review the parts applicable to your audit area and ensure your audit program includes steps to gather and analyze the data necessary to comply with the guidance. An outline is a useful tool in this process.

b. Chapter 10 presents specific requirements for all types of audit reports in 10-204 and subsequent paragraphs of Section 2. The remaining sections of Chapter 10 discuss various requirements for different types of audit reports. For example, section 10-300 describes price proposal audit reports. Section 10-400 describes functional and operations audit reports. Keep in mind that all reports must first meet 10-200 criteria, then, where applicable, the remaining Chapter 10 criteria.

c. Your report can be more effective and useful to the reader if you first present an overview or summary of the situation before going into detail. Make it easy for the reader to find your audit opinion, then follow with the detail supporting it. Your reader can then choose whether or not to read all the supporting material. This is the inverted-pyramid style of writing, which presents the most important point first and follows with supporting detail.

d. If you suffer from any form of "writer's block," you may use an outline to get started. You don't need to number or letter the outline, just get your thoughts onto the paper. Then revise as you draft the report.

10-104.3 Drafting the Audit Report

Write or assemble your rough draft using the appropriate structure or rough outline, including the CAM recommended paragraphs, with revisions to suit your needs. This may include comparing it to the appropriate checklist for CAM compliance. A very important part of the writing process is revision. If possible, prepare your draft report early enough to permit ample time for reviews and revisions by yourself and others.

10-104.4 Clarity and Precision in the Audit Report

a. Review the draft report to see if it is complete and balanced. Make sure you've followed the CAM guidance for your type of audit report. Then ask yourself, does it have the level of detail appropriate under the circumstances? Keep in mind that your report may be read by others besides the addressee and neither may be an auditor or accountant.

Does it read well and make sense to those outside of your profession as well as readers who may not be familiar with a particular contractor's practices or post-audit history? Will it prompt the action we want? A good audit report is clear and concise, expresses a well-founded audit opinion, meets the customer's needs, and is in accordance with the CAM guidance.

b. Make the report concise, but provide enough detail for it to be useful. This includes exhibits and supporting schedules—make sure that they are adequate. Do they provide enough information for a clear and complete explanation of the audit results and recommendations? When determining the amount of detail to include in the report, remember you are generally writing for more than one recipient or customer. Do these customers have the same background that you do? How knowledgeable are the customers about the subject? The report should be written so that the readers will fully understand the entire report, no matter how many words are needed. A good explanatory note to an audit report, for example, would discuss the following:

- the basis for the contractor's proposed or claimed amounts
- the scope of our audit
- the audit results with any references to the regulations used as criteria
- the contractor's reaction (except in proposal audit reports, judgmental items are usually not discussed with the contractor), and
- the auditor's response if the contractor disagrees with the audit results.

c. Verify the facts and check the calculations. Technical errors weaken a report considerably.

d. Reread the report just looking for grammatical and spelling errors. Use the spell-check feature on your word processing software to help. Make sure that all names are spelled correctly. Errors in spelling and grammar also weaken a report.

10-104.5 Responsiveness to the Customer in the Audit Report

The most important thing you must keep in mind is the immediate customer. The report must be useful to the primary report recipient—normally the address-

ee. To accomplish this, put yourself in place of the customer. Too often we forget that we are writing for others. Remember that our report accomplishes nothing unless the reader becomes better informed or is moved to action.

10-104.6 Readability of the Audit Report

a. Shorter words and sentences enhance readability. A busy reader will find the report easier to read—and act on. A sentence is wordy, or padded, when it includes words that add nothing to the meaning of the sentence. For example, compare the following sentences.

Wordy: It is our understanding that the contractor's estimates were prepared by using vendor quotations that are considered outdated.

Better: The contractor based its estimates on outdated vendor quotations.

Sentence length can be used to punctuate paragraphs the way commas and semicolons punctuate sentences. Vary your sentence length. Break long sentences into shorter ones. The average sentence length should be about 17 to 20 words.

b. Whenever you can, write naturally. Imagine talking to the reader in a professional situation. Don't try to inflate the report with impressive words. Use ordinary words that you and the reader will easily understand. Use short words in place of long ones whenever possible. Use action words and make writing direct rather than elaborately indirect. Use pronouns if the writing calls for them. For example, "At your request, we limited our audit to" correctly uses three pronouns "your," "we," and "our." Using contractions will make your writing more natural and will help you to avoid "bureaucratese." For example, "We didn't identify any material weaknesses in the internal control structure" uses a contraction while maintaining an appropriate professional tone.

c. Use a variety of punctuation—beyond the period and the comma—to

control emphasis and to help avoid monotony. Use the dash, for example, "The contractor didn't adequately support many key decisions—such as streamlining the acquisition process and entering production without a research and development phase." The dash sets off material that results from a break in continuity or thought in a sentence. The variety you provide with punctuation can help stimulate your reader's imagination, which aids in the delivery of your message.

d. Avoid the specialized jargon of auditing or of the bureaucracy; replace it with plain English. Jargon is specialized or technical language of a group that may not be understood by those outside of that group. Jargon interferes with comprehension for a variety of readers with differing backgrounds. Plain English will make our reports understandable to all readers.

e. Consider these examples of bureaucratic jargon and plain English replacements:

Bureaucratic

Jargon: Plain English:

afford an	
opportunity let	
due to the	
fact that	because
monetize	give a dollar value
utilization	use

Be vigilant in your choice of words and phrases. Use shorter, simpler words and phrases for easier reading. As a former President of the National Defense University instructed his staff, write so that his grandmother, who farms in remote North Dakota, would understand clearly.

(1) Jargon also can be any language which clouds a sentence's meaning by hiding its main subject and verb. Compare the following sentences:

Difficult: Excess starting load costs were allocated by the contractor to the terminated portion of the contract on the basis of an unrealistically low projection of the labor costs which would

have been incurred on the terminated units.

Better: Because the labor cost estimate was too low, the contractor allocated too much start-up cost to the terminated contract.

(2) Jargon also occurs when common words take on a special meaning within a profession and create confusion in the minds of those outside. For example, auditors frequently use the verb "monetize," meaning, to them, to determine a monetary value. This usage completely misses the mark. Monetize actually means (a) to coin into money, or (b) to legalize . . . money. It should not appear in an audit report. Search for substitutes, such as "We have calculated the dollar value of the technical recommendations."

(3) Also taking on special meaning are acronyms or abbreviations. As you review the draft, substitute complete words for acronyms. If an acronym is used frequently and is commonly understood by the report users, provide the complete words the first time followed by the acronym in parentheses—for example, total quality management (TQM). Or, reverse the order if the acronym is more familiar than the words. In such case, provide the acronym first, followed by the words it stands for in parentheses—for example, NASA (National Aeronautics and Space Administration). When in doubt about the familiarity of the acronym or abbreviation to potential readers, don't use it. Acronyms should be redefined periodically throughout the report. They should be redefined when first needed in each section of the report and possibly every two to three pages.

(4) Some words are used incorrectly in audit reports. "Unsupport" and "unresolve," used as verbs, are prime examples. "Unsupported" and "unresolved," when used as adjectives, are perfectly acceptable. An example of the correct usage is "The contractor's tooling costs are unsupported," but "We unsupport the tooling cost" is not correct usage.

10-104.7 The Visual Impact of Your Audit Report

a. Visual presentation is an important part of communicating. Use headings to set off main points and "bullets" to highlight items in a sequence. They catch the reader's attention and enhance comprehension. For example,

A bullet list is effective for listing points:

- it emphasizes each one
- it's easier to see the items
- it creates more space around each point

b. Charts and graphs can be used to summarize voluminous amounts of data in a meaningful and concise manner. They add variety and employ another of the reader's senses, thereby reinforcing the message.

c. The effective use of white space (a term from printing meaning that part of the page that does not have any ink printed on it) can make a report more inviting to the reader. If a paragraph has more than 10 to 15 typed lines, consider dividing it into two paragraphs. You can highlight extracts from regulations or the contractor's policies by separating and indenting them as a block.

10-104.8 Active and Passive Voice

a. Using the active voice in your writing improves comprehension. Knowing the difference between the active and passive voice requires understanding the grammatical structure of sentences. A complete sentence has a subject and a verb. For example, "The auditor wrote the report" is a complete sentence. It is also in the active voice. It's in the active voice when the grammatical subject (the auditor) is doing the action expressed in the verb (wrote). The active voice sounds more natural and is easier to understand.

b. Let's look at the same event expressed in the passive voice: "The report was written by the auditor." In this case, the grammatical subject (the report) has the action of the verb performed on it (was written). A sentence is in the passive voice when the subject receives the action of the verb.

c. Sometimes voice is confused with tense. Voice indicates whether the subject

is doing the action (active voice) or is receiving the action (passive voice). Tense only indicates time or duration. A sentence in the active voice can be in forms of past or present tenses—"The auditor wrote the report" or "The auditor is writing the report." Both of these examples are in the active voice but are in different tenses.

d. Bureaucratic, the language of the bureaucracy, often uses the passive voice because it is easier to avoid saying who is doing the action. In the sentence in the passive voice "The report was written," there is no mention of who did the writing. Writing in the active voice forces you to say who is doing the action: "The auditor wrote the report." This makes your writing stronger and easier to visualize and understand.

e. Some use of the passive voice is okay when the doer of the action is understood and perhaps not important to what you are saying. As a rule, limit your use of the passive voice.

Passive voice is appropriate when the doer is

- unknown
- unimportant
- deliberately de-emphasized
- obvious to the customer

10-104.9 Modifiers

a. Place modifiers in sentences so they are close to the words they define. A modifier makes the meaning more specific. When a modifier is too far from the word it modifies, the reader may connect the modifier to some other word. The reader may also be confused when a modifier ambiguously appears to modify two words. The following sentence illustrates what can happen when the modifier is too far from the word it modifies:

You hold the hammer while I hold the nail, and when I nod my head, you hit it.

b. Too many modifiers weaken writing. The strings of words or phrases often bury the subject and confuse the reader.

Observe this example of a string of words that together modify the last word: "nonrecurring cost recoupment charge internal controls." The first five words say what kind of controls there are, but it is difficult to read. An improved version is "internal controls for recoupment of nonrecurring cost."

10-104.10 The Reader's Perspective

a. The tone of the report should be objective, professional, and courteous. Use plain English as in a relaxed, professional talk. Writing can be somewhat informal in tone yet professional and businesslike. Keep in mind that the goal is to get a favorable reaction. Avoid using accusatory, inflammatory language—this is likely to generate defensiveness and opposition. In presenting problem areas, emphasize improvements needed.

b. Lastly, review the draft from the customer's perspective, which should be the main focus. Is the report thoroughly responsive to the customer's request? Remember that a report accomplishes nothing unless it is useful to the reader.

10-104.11 Final Steps

Before submitting your report for supervisory approval, check again to ensure your report complies with CAM guidance. Also, consider having a colleague read your audit report—not to rewrite your report in his or her own personal style, but rather to provide a much-needed critical review for content and the good writing techniques such as those outlined in this section. If a colleague is not available, read the report out loud to yourself. If it does not sound natural to you, it will probably not seem natural to the reader either. If you don't understand, your reader won't either. Another point of view, such as from your colleague's critique or from your reading it out loud, can help you develop a final draft needing little or no revision by your supervisor.

10-200 Section 2 — Format and Contents of Audit Reports—General**10-201 Introduction**

a. This section discusses DCAA requirements governing audit report content; details the general administrative and format requirements of audit reports; lists and defines the elements of audit reports in their order of appearance in the report; summarizes DCAA policy regarding protection of report information; and provides guidance on audit report distribution. It also explains the circumstances under which supplemental and short form audit reports should be issued and describes the recommended format for these reports.

b. The guidance included in this section is general in nature and applies regardless of the type of audit report being prepared. Specific report preparation requirements for various types of individual audit assignments are discussed in the remaining sections of this chapter.

10-202 Reporting of Audit Results

To satisfy government reporting standards (2-400 and 2-600), there must be a written record of the results of each audit. Normally this requirement is satisfied by issuing an audit report. Certain situations, however, may call for preparation of a "MEMORANDUM FOR RECORD" (refer to DCAAM 5020.1, Correspondence Manual) rather than an audit report. This may be appropriate, for example, upon completion of an individual overhead account audit which represents only one portion of a final overhead audit report to be issued later, and the individual audit did not result in system deficiency or economy and efficiency findings that must be reported to contracting officers. Under no circumstances will reports be addressed "to the file" or "for the record" (10-208.1).

10-203 General Administrative Requirements**10-203.1 Paper**

a. Prepare reports on 8 1/2 by 11 inch paper. If wider sheets are needed for

tabulations, fold or reduce them to the size of the other sheets.

b. Stationery will be white bond paper or equivalent of a grade, weight, and substance as available through normal supply channels. When word processing equipment is used, paper supplied with the computer is acceptable for audit reports. However, the first page of the narrative must include the letterhead.

10-203.2 Margins

Margins will be uniform; allow 1 inch for left and right margins and at least 1 inch at the bottom of the page. There will be at least two lines between the last line of typing and the page number.

10-203.3 Typing

a. General. Computer equipment should be used to the extent possible to prepare all portions of the report, including exhibits and rate schedules. Working papers should never be included in the report.

b. Spacing and Typestyle. Lines of typed material will be single spaced, not exceeding six lines per vertical inch and 12 characters per horizontal inch. If available, Prestige Elite or the typestyle closest to it should be used. Schedules, listings, and similar material should be presented in the best manner for appearance and readability.

c. Paragraphing

(1) Underscore paragraph titles in both the narrative and report body for all major subjects, and also for lesser items where appropriate. Put paragraph captions on separate lines and do not include periods or other punctuation after paragraph captions (see Figure 10-2-3).

(2) The first sentence of main paragraphs should be indented five spaces from the left margin. Subparagraphs will be lettered or numbered (arabic numbers only, not roman numerals) if there are two or more; when there is an "a", there must be a "b", etc. Use the following numbering sequence in reports:

1. Title and beginning of paragraph should begin at the left margin as shown in Figure 10-2-3.

10-203.3c.

a. Indent 5 spaces from left margin.

b. xxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxx

(1) Indent 9 spaces from left margin.

(2) xxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxx

(a) Indent 14 spaces from left margin

(b) xxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxx

1. Indent 19 spaces from left margin.

2. xxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxx

(3) Any subparagraph after a lower case letter in parentheses [(a), (b)] is discouraged. Try to use paragraph captions wherever possible to avoid this.

d. Capitalization

(1) The audit report cover sheet (10-206) should include the audit report number, subject, office identification, and "FOR OFFICIAL USE ONLY" designation in upper case letters, as shown in Figure 10-2-1. The month is written in lower case with an initial capital. The title of each exhibit, schedule, or appendix and its designation (EXHIBIT A, SCHEDULE B-1) should also be in upper case letters, as shown in Figure 10-3-2. The words "SUBJECT", "TO", and "THRU" (if applicable) in the report subject and addressee elements are also shown in upper case letters. All other portions of the report, including the report subject and addressee, all paragraph titles, table of contents descriptions, and exhibit/schedule line item descriptions, will be in initial capitals only except for articles, prepositions, and conjunctions (see Figure 10-2-3).

(2) Do not capitalize the noun designating elements of the report, such as page, appendix, attachment, or paragraph, unless they are part of a title (for example, Appendix B and Attachment 3). Also, do not capitalize the word "government", or words such as manager, contracting officer, procurement office.

10-203.4 Date

Express the day, month, and year of the audit report in the order named (for example, 16 December 1989).

10-203.5 Page Numbering

a. Consecutively number pages at the bottom center of the page, beginning with page 2 of the narrative and continuing through the exhibits and schedules. Do not offset page numbers with periods, dashes, or other punctuation. Each page of an exhibit, schedule, or appendix should also be indicated at the top right margin. For example:

EXHIBIT A	SCHEDULE A-1
Page 1 of 10	Page 7 of 8

b. If a table of contents or distribution list is included in a report and extends for more than one page, number them at the top right margin to indicate the specific page in the same manner as exhibits, schedules, and appendixes (for example, page 1 of 2). No other page numbering is necessary.

c. If DCAA assist audit reports, government technical reports, or other documents that are individually numbered are included in a report as appendixes, it is necessary to number only the first page of the document. In cases where many appendixes are included in a report, it may be convenient to preface each appendix with a blank sheet indicating the title of the appendix and page number rather than making any annotations on the particular document.

10-203.6 Numbering Audit Reports

a. Heads of field audit offices are responsible for assigning report numbers to all audit reports. The audit report number is the assignment number prefixed by the regional organization code (RORG). The audit report number will be shown at the top left margin of each page of the report in initial capitals, as shown in Figure 10-2-3. The words "AUDIT REPORT NO." will precede the audit report number in the top left margin of the report cover sheet (10-203.3d and Figure 10-2-1).

b. The FAO, at its option, may include on the audit report cover sheet directly

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¶10-203.6b.

under the audit report number a chronological reference number known as a "chron number." The use of the chron number is discussed in DCAA's FAO Administrative Manual (DCAAM 5020.9). The chron number should not appear on any other page of the audit report except the cover sheet and should appear as follows:

AUDIT REPORT NO.
3258-93A21000001
CHRON NO. 0023

10-203.7 Report Assembly and Reproduction

a. Producing an "Original" and Copies. Reports should be reproduced by the most efficient and economical means which ensures a professional appearance. One copy of the report must be clearly identifiable as the original by stamping "Original" on the cover sheet and in the upper right corner of the letterhead page. The "original" copy of the report must be signed by an auditor with the authority to do so (10-210). To provide positive evidence of the authorized signature, copies of the original signature page should be used on additional report copies rather than a rubber stamp depicting a signature.

b. Fastening. Reports will be securely fastened at the left margin. Thus, any tabulations or graphs, for example, must be positioned with their headings either at the top or at the left side of the assembled report.

c. Report Covers. If an audit report cover is required (10-205), the report title on the cover sheet will be visible through the window in the cover. Report titles should be short enough to fit in the cover window.

(1) Each FAO will use the standard audit report covers provided by Headquarters. If a cover is used, a sheet of standard light blue index stock should also be added at the back of the report.

(2) The cover is preprinted "FOR OFFICIAL USE ONLY" and will not carry any other audit report identification. No FAO entries are required on the cover unless the report is classified or pertains to a classified subject (10-205.2).

10-203.8 Insignificant Amounts/Elimination of Cents

a. Only significant amounts of questioned costs should be displayed in audit reports. The materiality criteria in paragraph 331.71(a) of the CASB rules and regulations should be considered in making this determination. These criteria are: absolute dollar amount; ratio of the amount of an item to an appropriate base figure; relationship between a cost item and cost objective; the impact on government funding; the cumulative impact of individually immaterial items; and the cost of administrative processing of the price adjustment modification.

b. Cents should not be included in audit reports except when necessary for comprehension of the report; e.g., in the case of unit cost reports or unit cost tabulations.

10-203.9 Use of Rubber Stamps

a. Rubber stamps should be used to designate the "original" of the audit report (10-203.7a). While restrictive markings ("FOR OFFICIAL USE ONLY" or appropriate security classification) may also be affixed by rubber stamp, it will generally be more efficient to type this if word processing equipment is available (see Figure 10-2-1).

b. The audit report should be dated the day it is signed. The date should be typed rather than stamped on the original to obtain a more legible imprint for reproduction. Rubber stamps should not be used for the signature (10-203.7a).

10-203.10 Protection of Report Information

a. All DCAA audit reports not containing classified information are "FOR OFFICIAL USE ONLY." Mark and handle them in accordance with Chapter 4, DoD 5400.7-R, "Freedom of Information Act Program." Reports containing classified information will be prepared, classified, marked, and protected in accordance with DCAAM 5205.1, "Information Security Program." To the extent possible, limit classified material included in the report, because audit reports must be classified at the highest security classification contained therein. Also see 10-

10-203.10a.

205.2 if the report pertains to a classified subject.

b. Reports that do not contain classified information will be marked "FOR OFFICIAL USE ONLY" at the bottom on the outside of the front cover, if applicable (preprinted on the covers provided by Headquarters -see 10-203.7c), on each page of the report, and on the outside of the back cover (if any).

10-204 Audit Report Format

Major audit report components are listed below in the sequence in which they generally appear. They are discussed in detail in the referenced paragraphs. Those components highlighted with an asterisk should appear in every DCAA audit report, regardless of type, to satisfy minimum professional standards. Other elements may or may not be included in a particular report depending on the type of audit performed or other circumstances. For example, "circumstances affecting the audit" is not identified with an asterisk but becomes a mandatory report requirement if existing conditions require its use. Elements pertaining only to certain report types are indicated. Refer to the remaining sections of chapter 10 for additional guidance on audit report preparation for specific types of audit assignments.

Audit Report Cover (10-205)
 Audit Report Cover Sheet (10-206)*
 Report Subject (10-207)*
 Addressee (10-208)*
 Report Narrative (10-209)*
 Purpose and Scope of Audit (10-209.1)*
 Circumstances Affecting the Audit (10-209.2)
 Statement of Changes (CAS reports only - see 10-803b)
 Background Information
 Summary of Audit Results (10-209.3)*
 Statement of Conditions and Recommendations (Functional and CAS reports only - see 10-413a and 10-803b)
 Cost Impact (CAS reports only - see 10-803b)
 Status of Corrective Action Taken on Prior Recommendations (Functional reports only - see 10-408)

Unsatisfactory Conditions and/or Other Audit Recommendations (Postaward and claim reviews - see 10-605.4 and 10-1104.4)

Contractor's Reaction (Postaward and claim reviews - see 10-605.5 and 10-1104.5)

Disposition of Audit Results (10-209.4)*

Signature block (10-210)*

Report Distribution (10-211)

Table of Contents (10-212)

Data Sheet (10-213)

Exhibits, Schedules, and Appendixes (10-214)

Attachments (10-413c and 10-503e)

DCAA Summary Sheet (10-215)

* Required in every report regardless of type

10-205 Audit Report Cover**10-205.1 Criteria for Use**

a. Use covers on the following types of reports distributed outside of DCAA to enhance their professional appearance. If the particular report category is highlighted with a double asterisk, a cover is required only if the contractor is classified as "major contractor" for audit planning purposes.

(1) Reports concerning (a) apparent defective pricing, or (b) significant non-compliance with Cost Accounting Standards or similar statutory requirements or regulations.

(2) Reports involving matters possibly subject to investigation or particularly significant or sensitive for other reasons.

(3) Reports on audit of price proposals over \$50 million, and lesser amounts if the report recommends FAO attendance at the negotiation conference.

(4) Reports addressed to non-DoD officials other than those non-DoD PCOs and ACOs with whom the FAO may deal regularly in procurement or contract administration matters.

(5) Reports that contain a security classification or pertain to a classified subject (see 10-205.2).

** (6) Reports on annual indirect costs.

** (7) Reports on functional/operational reviews (other than joint

reviews under DFARS 242.70) that contain recommendations for contractor corrective action or cost avoidance. This category includes reports on estimating system surveys.

******(8) Reports pertaining to more than one contractor segment, such as reports on coordinated audits performed within a Contract Audit Coordinator complex.

******"Major contractor" only

b. The DCAA cover is inappropriate for reports signed jointly under the DFARS 242.70 cost monitoring program. The joint review team should develop an appropriate cover for these reports.

c. Subject to these minimum requirements, FAO managers may use discretion in determining if report covers should be used in other situations. However, covers should be omitted on minor reports, particularly those that require limited or no specific action by their addressees.

10-205.2 Covers for Reports on Classified Subjects

a. If the report contains a security classification (see 10-203.10), the classification marking must replace "For Official Use Only" on the report cover. This may be done by crossing out the preprinted "FOR OFFICIAL USE ONLY" legend and stamping both the top and bottom of the audit report cover with the appropriate security classification. If a stamp for the appropriate classification is not available, classification markings should be made in letters conspicuously larger than the size of the print of the report.

b. If an audit report pertains to a proposal or a contract that is classified or includes classified elements, and the auditor is unable to determine the appropriate security classification of the report, a special "warning" label (DCAA label 5) must be affixed (see DCAAM 5205.1, Section 1-400.b). The label is placed above, but not covering, the "FOR OFFICIAL USE ONLY" legend on the audit report cover, and the report must be sent via registered mail. Contact the regional security officer for instructions prior to release of the report. Regional offices should consult with the Headquarters

security officer if questions on this procedure should arise.

10-206 Audit Report Cover Sheet

10-206.1 General

a. A cover sheet is required for every report. The general format is shown in Figure 10-2-1. The last three paragraphs in the figure, concerning (1) Freedom of Information Act requests, (2) the proprietary nature of contractor information included in the report, and (3) restriction on release of the report outside the Department of Defense, must be included verbatim on all cover sheets. The first paragraph of a cover sheet must be omitted in certain cases, or will vary according to the type of report (10-206.2) and the relationship of the entity audited to the government — prime contractor or subcontractor (10-206.3).

b. Include the audit report number, date of report, title of report, address of the issuing office, and restrictive marking ("FOR OFFICIAL USE ONLY" or other appropriate security classification) on the cover sheet as presented in Figure 10-2-1. The title of the audit report should agree with the "subject" block (10-207 and Figure 10-2-3).

10-206.2 Release of Audit Reports to the Contractor

a. As provided for in the Government Auditing Standards on Reporting, DCAA routinely provides copies of draft reports for all audits, except those dealing with negotiation of forecasted costs, to the contractor being audited. (See also 4-303 and 4-304 regarding information to be discussed at interim and exit conferences.)

b. DCAA audit reports that do not contain opinions on forecasted costs are generally provided to the contractor at the exit conference in draft form for written comment. The contractor should be provided a reasonable amount of time to analyze the audit results and to submit its response for incorporation into the final audit report. If the contractor's response is not provided in a timely manner, the final report should be issued stating that the report was provided for

comments to the contractor but the comments were not received in time to incorporate them into the final audit report. If written comments are received after the audit report was issued, prepare a supplemental audit report if it will serve a useful purpose. The following types of draft audit reports are generally provided to the contractor for written response prior to issuing the final audit report.

- Incurred Cost Submissions
- Contract Audit Closing Statements, if exceptions are found
- Cost Accounting Standards Reports, including cost impacts
- Postaward Reviews, if defective pricing was found
- Provisional Billing Rates
- Progress Payment Audits, but not proposals for special or flexible progress payment rates or interim changes in contract prices
- Other Special Audits, such as Facility Rental and CFSR
- Financial Control Audits
- Billing System
- Compensation
- EDP General and Application Control Reviews
- Estimating System
- General Accounting System
- Indirect Cost Accounting System
- Labor Cost Accounting System
- Material Cost Accounting System
- Planning and Budgeting System
- Purchasing System
- Other Internal Control Reviews
- Preaward Accounting System Reviews
- Operation Audits
- Equitable Adjustment and Termination Submissions, if based entirely on incurred costs
- Joint Contractor Insurance/Pension Reviews (CIPR)
- Financial Capability Audits
- System Surveys at Contractors with no ADV
- Joint Reviews of Contractor Operations, including those required under DFARS 242.70 "Monitoring Contractor Costs"

Except for reports on postaward reviews, audits of equitable adjustment and termination submissions, and the reports discussed in the paragraphs below, the

final audit report will show the contractor as a distributee of the report (through the contracting officer). Final reports provided to the contractor through the contracting officer should omit the first paragraph shown in Figure 10-2-1 related to DCAA having no objection to the release of the audit report. If the contractor requests a copy of these type of final reports after the report has been issued, coordinate with the contracting officer to determine if the contracting officer has any objection to DCAA providing a copy of the report directly to the contractor.

c. Draft audit reports which include forecasted costs are not provided to the contractor unless specifically authorized by the contracting officer (FAR 15.805-5(f)). Also, the Procurement Integrity Act restricts the discussion of source selection information with an offeror other than for the purpose of minor clarification (FAR 15.6). However, the auditor should fully discuss with the contractor any factual differences, unsupported items, cost or pricing data inadequacies, and CAS/FAR noncompliances and obtain the contractor's response for inclusion in the final audit report. Draft and final audit reports on the areas listed below are not provided to the contractor unless specifically requested by the contracting officer.

- Individual Price Proposals
- Should Cost Reviews
- Forward Pricing Rate Proposals
- Reviews of Part of a Proposal
- Agreed-to Procedures Audits
- FPR/FPI Price Redetermination Proposals, containing forecasted costs
- Equitable Adjustment and Termination Submissions, containing forecasted costs
- Limitation of Payments Submissions
- Proposal for Special or Flexible Progress Payment Rate or Interim Changes in Contract Price

The following contingent release statement shown on Figure 10-2-1 will be included as the first paragraph on the cover sheet for these reports.

"The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized

representatives of [insert name of contractor or subcontractor to which the report pertains]."

d. Draft and final reports that are of a privileged and sensitive nature (such as those reporting on unsatisfactory conditions (4-803.2) or which make reference to suspected irregular conduct or referral for investigation (4-700)) will not be provided to the contractor. These types of reports are not usually discussed with contractor representatives, and any inquiries concerning disclosure of the report information will be resolved in accordance with DoD 5400.7-R and the DCAA Freedom of Information Act Program.

e. The statement regarding release of the audit report solely at the discretion of the cognizant contracting agency pertains to the complete report including all appendixes. Frequently, a government technical evaluation report may be included as an appendix to the DCAA audit report. If, for any reason, the government activity supplying a technical evaluation has any objection to release of its report to contractor representatives, this must be highlighted on the cover sheet. For example:

"The Defense Contract Audit Agency has no objection to release of this report. However, the government technical evaluation report included as Appendix xx of our report should not be released to [insert contractor or subcontractor name] without approval of [insert name of government agency supplying technical report]."

10-206.3 Release of Subcontract Audit Report to the Higher-Tier Contractor — Proposals or Other Cost Submissions

a. When the report is on a subcontractor's proposal or other cost submission to a higher-tier contractor, the cover sheet must contain a statement regarding the subcontractor's agreement or objection to release of the report to the higher-tier contractor. The release statement applies to all subcontract audit reports, regardless of the audit report type. The audit procedures on this matter are discussed

in 9-106.4 for price proposals and 6-801.2 for incurred costs. The auditor should have determined at the start of the review whether the subcontractor would have any restrictions on release of the report to the higher-tier contractor. If so, the auditor should have also discussed with the requestor how the audit results could best be presented to maximize their usefulness to the recipient.

b. The comment regarding subcontractor release restrictions will be included in the first paragraph of the cover sheet. It will appear either as a stand-alone comment or as a follow-on comment to the sentence provided in 10-206.2c, if required. See Figures 10-2-2(a) and 10-2-2(b) for sample formats.

c. If the subcontractor does not object to release of the report, use the following statements.

(1) If the sentence in 10-206.2c is required, add the following as the second sentence in this first cover sheet paragraph.

"Nor does this Agency or [insert name of subcontractor] object to release of this report to authorized representatives of [insert name of higher-tier contractor]. See Appendix xx for a copy of the subcontractor's release statement."

(2) If the sentence in 10-206.2c is not required, the comment on subcontractor release restrictions becomes the first paragraph of the cover sheet, as follows:

"[Insert name of subcontractor] does not object to release . . ."

d. If the subcontractor objects to release of all or any part of the report information, use a cover sheet statement similar to the following:

The [insert the subcontractor's name] objects to release of this report to the higher-tier contractor, [insert the name of the higher-tier contractor], because [briefly summarize the reason(s) for the subcontractor's objection. If applicable, identify the specific information the subcontractor does not want released]. Therefore, report information

should be kept within government channels except to the extent that the subcontractor grants permission for its release. See Appendix xx for a copy of the subcontractor's statement of objection to release. However, the Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of [insert name of contractor or subcontractor to which the report pertains]."

- e. If the subcontractor restricts release of only a portion of the report information (for example, historical labor hours), try to contain the restricted data in a schedule or appendix that can be conveniently removed from the report. In such a situation, the report cover would include a statement describing what information cannot be released and advise that the report could be released if the restricted data are first removed. For example:

"The [insert the subcontractor's name] objects to release of this report to the higher-tier contractor, [insert the name of the higher-tier contractor], unless Schedule/Appendix xx is first removed, because it contains [identify the data and briefly state the reason(s) for the subcontractor's objection]. Therefore, report information should be kept within government channels. However, the Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of [insert name of contractor or subcontractor to which the report pertains]."

10-207 Report Subject

- a. The report "Subject" element should agree with the audit report title as shown on the cover sheet (10-206.1b). It should begin with a description of the audit performed (e.g., Report on Audit of Proposal for Initial Pricing, Report on Audit of Labor Costs, Report on Postaward Audit of Cost or Pricing Data, etc.). Depending on the type of audit, the

subject may include references to the RFQ/RFP or prime contract number, subcontract identification, if applicable, disclosure statement revision number, etc., and the contractor's name, city, and state.

- b. Specific information that should be included in the report subject for particular types of reports is described in the applicable sections of this chapter. Refer to Figure 10-2-3 for an example of the subject element.

10-208 Addressee

10-208.1 Prime Contract Report Addressees

- a. It is DCAA policy that audit reports at the prime contract level be addressed to a contracting officer unless it is clear that another acquisition official will be responsible for resolving the audit findings and recommendations. Under DoD field pricing support procedures (9-100), for example, the addressee would normally be the procuring contracting officer (PCO) unless a plant representative/administrative contracting officer (ACO) has been delegated procurement authority to execute the particular contract action. This policy results in audit findings being directed to the individuals responsible for resolutions and facilitates timely contracting officer action.

- b. Even if the audit report does not contain findings requiring resolution, the report addressee should normally be the cognizant contracting officer. Under no circumstances will reports be addressed "To the File" or "For the Record."

- c. A number of non-DoD agencies make requests for audit through their Offices of Inspectors General, which may be responsible for arranging audits for many procurement offices. The assigned number or other assignment identifier contained in the audit requests is their primary means of identifying these assignments. To help these offices control their assignments and expedite transmittal of reports to responsible officials, non-DoD agency assignment numbers, or other assignment identifiers contained in requests for audit, will be included within

the first one or two sentences of audit reports issued to these agencies.

d. Audit reports in support of team system reviews led by contract administration organizations, such as the Contractor Purchasing System Review (5-1302) or the Contractor Insurance/Pension Review (5-1303), should be addressed to the designated team captain. Reports on should-cost team reviews (9-1300) will be addressed to the PCO. Audit reports on C/SCSC demonstration reviews (11-202.3) will be addressed to the review director; reports on C/SCSC surveillance reviews (11-202.4) will be addressed to the lead acquisition activity through the principal cognizant ACO (see 10-208.4). Reports required to support an investigation will be addressed to the requester.

e. The audit report distribution (10-211) should include the team leader as a distributee of the report (provide as many copies as requested). Also, continue to provide the team leader with all information necessary for the review in accordance with applicable CAM guidance, such as a copy of the draft report for use during the exit conference, and copies of any summary schedules or working papers required for consolidation of statistical data or supporting documentation.

10-208.2 Subcontract and Intracompany Report Addressees

Most FAO audit reports on intracompany and subcontract matters will also be addressed in accordance with 10-208.1. In certain audit areas, however, such as postaward reviews of cost or pricing data (10-600), procurement needs may be better served if the auditor's report from the other company segment or subcontractor level is addressed to the contract auditor at the prime contract level. The recipient auditor will then incorporate the findings and recommendations into a single audit report for action by the responsible contracting officer. Appropriate variations in addressing and distribution of intracompany and subcontract reports will be covered in later sections of this chapter (see 10-303.2, 10-604, and 10-704).

10-208.3 Form of Addresses

As a matter of form, audit reports are not normally addressed to an individual by name but to the title of the position. However, if the report is for an office with several contracting officers, the first line of the address block should identify the individual in some appropriate manner. This may be done by placing the ACO/PCO's room number, "desk code," "mail stop," or name in parentheses following the contracting officer designation. For example, report addresses may begin: "Procuring Contracting Officer (Code 03D-1)" or "Administrative Contracting Officer (Ms. Mary Z. Brown)."

10-208.4 "Through" Addressing

When required to route the original copy of a report through an intermediate action office other than the addressee's office, use "through" addressing. Under DoD field pricing support procedures (9-100), for example, if a report on review of a price proposal is addressed to a PCO (other than the plant representative/ACO acting as a PCO) but is to be routed through the ACO, the "TO" element will be followed by a "THRU" element, as illustrated in Figure 10-2-3.

10-208.5 Attention Lines

It is acceptable to use a separate "Attention" line as the second line of the "TO" and/or "THRU" address block when the addressee has requested the FAO to route the report directly to a particular organizational section or individual within the addressee's office. Do not use an "Attention" line to identify the contracting officer to whom the report is addressed (see 10-208.3).

10-209 Report Narrative

All reports must have a narrative body which as a minimum includes comments on the purpose and scope of the audit, any limitations on the scope of audit performed, a summary of the audit results, and the disposition of audit results. This part describes in general terms the content of each of the narrative paragraphs to be included in audit reports in the order in which they are to appear.

The remaining sections of this chapter in many cases expand on the content of each of the narrative paragraphs as they apply to particular types of reports, such as price proposals, cost accounting standards, postaward reviews, etc.

10-209.1 Purpose and Scope of Audit (mandatory paragraph)

a. Begin this section by identifying the functional area or contractor submission reviewed and the purpose and objectives of the review. Identify the audit request, if applicable, including specific reference to any case numbers or assignment identifiers contained in the audit request. In many instances, especially when non-DoD inspector general offices arrange audits for their agencies, the assignment identifier included in the request is the primary means of tracking these assignments.

b. Depending on the nature of the audit, information may be included regarding the time period of the audit, date, dollar value, and type of proposal, period of performance of the proposed effort, and contract data such as type, incentive provisions, etc. Audit reports on price proposals should also include statements about additional cost or pricing data submissions and due date extensions, if applicable, indicating what additional data were reviewed, the reason the extension was needed, the official who granted the extension, and the correspondence confirming the extension.

(1) An example of a statement that could be included in a report on a price proposal follows:

"As requested by [insert requesting office name] letter dated [insert date of request], reference [insert requester reference number], we have audited [insert contractor's name] proposal dated [insert date of proposal] for \$ [insert total proposed price including profit or fee, if any]. This [insert type of proposal] proposal provides for [insert description of service or product to be provided]. The proposed performance period is [insert inclusive dates of contract performance]. We have also audited the additional supporting cost or

pricing data specifically identified in the contractor's letter(s) dated [insert dates of contractor supplemental submissions of cost or pricing data]. [Insert identification of official who granted the extension(s)] extended the original audit report due date of [insert original due date] to [insert revised due date] because of [insert reason(s) extension was needed]. We sent you a copy of our [insert date of correspondence confirming the due date extension(s)] memorandum confirming this due date extension.

"The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our audit."

(2) An example of a statement that might be included in a report on a functional/operational review follows:

"As part of our comprehensive audit of the [insert company name], we reviewed the contractor's plant maintenance function which is responsible for the maintenance and repair of equipment and buildings at the Boston facility. The audit was performed to evaluate the effectiveness of the contractor's policies and practices in assuring that maintenance tasks are carried out in a timely, efficient, and economical manner. The audit was conducted from November 1988 through February 1989 and covered contractor operations for the fiscal year ended 31 December 1988."

(3) The purpose of audit paragraph should also include appropriate special comments if the audit review was limited to specific functions or activities, if particular work was or was not performed, or if special aspects were considered in performing the review, perhaps at the request of the contracting officer. For example:

"At your request, we limited our audit to. . ."

c. Introduce the scope of audit paragraph with the following statement, modified as shown where appropriate:

"Except as discussed in paragraph 2 [omit if no "circumstances affecting the audit" paragraph is included in the report], we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion."

(1) The above paragraph should also identify the established or stated criteria against which the proposal, submission, functional area, etc. was measured. As a result, additional comments in this paragraph will vary depending on the type of audit work performed. For example, reports on reviews of revised disclosure statements will state that the requirements in 48 CFR 9903.202 were used as criteria in ascertaining the adequacy and compliance of the contractor's revision. Reports on postaward reviews may indicate the criteria used to evaluate the cost or pricing data were DoD's implementation of the law contained in FAR Subpart 15.8 and pertinent provisions of the contract. In a report on a functional area, indicate the types of contractor records and documents examined and the specific audit steps and techniques used.

(2) A report on a price proposal review should include an additional scope of audit statement, modified as appropriate depending on contractor CAS coverage. The following examples show the statements that should be included (a) when full CAS coverage is applicable and (b)

when the small business exemption appears appropriate:

(a) "The cost or pricing data requirements and cost principles contained in the Federal Acquisition Regulation and DoD FAR Supplement (DFARS) [for non-DoD agencies, identify specific agency supplement - see 9-102.2 and 15-102.2] and the practices required by applicable Cost Accounting Standards were used as criteria in evaluating the contractor's submission."

(b) "The cost or pricing data requirements and cost principles and procedures contained in the Federal Acquisition Regulation and DoD FAR Supplement (DFARS) [for non-DoD agencies, identify specific agency supplement - see 9-102.2 and 15-102.2] were used as criteria in evaluating the contractor's submission. The contractor claims exemption under 48 CFR 9903.201-1(b)(3) from the practices required by Cost Accounting Standards board rules and regulations because it considers itself a small business concern."

(3) If a government technical review was performed in conjunction with the audit review, the auditor will in normal circumstances incorporate the technical report recommendations into the audit conclusions (note the exception discussed under 10-209.2). In such cases the audit report should include an additional scope statement, such as the following:

"The audit conclusions reported in Exhibit A incorporate the dollar effect of the recommendations in the related government report of technical evaluation performed by [insert name of activity providing the review]."

(4) If a joint report is being prepared under a cost monitoring program, a technical scope statement may be added as a separate paragraph at the technical representative's discretion (10-403b).

(5) The last paragraph of the scope statement should describe the work performed to obtain an understanding of relevant internal control structure policies and procedures and to assess control risk.

(a) For audits of the contractor's accounting and management systems, the Scope of Audit section should explain that this audit includes:

- (i) obtaining an understanding of the internal controls
- (ii) determining if the controls are adequate and in operation
- (iii) listing the control objectives covered by the audit
- (iv) assessing control risk to use as a basis for planning the testing necessary in other financial related audits

Refer to 10-400 for details.

(b) For other financial related audits, (e.g., forward pricing proposals, progress payment requests, annual incurred cost audits) provide the following information on how the contractor's internal control systems affected the scope of audit:

(i) At those contractors with internal control systems, list those systems that provide for compliance with laws and regulations for the area being reviewed, describe how assessed control risk was considered in determining the scope of audit, and refer to the contractor Organization and Systems section for the current status of the system(s).

(ii) The Contractor Organization and Systems section of the report should reference the last audit report and our current opinion on the overall system, describe the current assessment of control risk, and list any outstanding internal control deficiencies along with the current status of those deficiencies. See 5-100 for additional information on internal control reviews.

(iii) At smaller contractors that do not have defined internal control system or non major contractors where it was not beneficial to review the system, the scope paragraph should state that fact and state that as a result control risk was assessed as high.

10-209.2 Circumstances Affecting the Audit

a. Circumstances having a significant adverse effect on the conduct or scope of the audit should be clearly identified if the conditions result in qualified audit conclusions in relation to the stated purpose and scope of the review. In such case, both the "purpose and scope of audit" and "summary of audit results" paragraphs should specifically refer to this paragraph. Examples of items that may be presented in this paragraph include but are not limited to: (1) lack of access to or inadequate contractor records, (2) time limitations on the scope of audit, and (3) failure to obtain a required government report of technical evaluation or assist audit report.

b. The nature and potential impact of each circumstance and any steps taken by the auditor to overcome or mitigate the problem described (e.g., request for additional review time, etc.) must be explained. Also explain further action the auditor plans to take after report issuance, if applicable. Where possible, keep this paragraph brief and include specific references to the report exhibit, schedule, or appendix paragraph that contains a detailed discussion of the item involved.

c. If a required government technical report is not received, indicate the reason for nonreceipt and any follow-up action to obtain the report from the organization involved. State the specific areas in which technical review is required to conclude the audit. Also recommend that the auditor be given an opportunity to review the results of the technical evaluation, determine its impact on the scope of audit and overall conclusions, and provide a supplemental report incorporating such evaluation.

d. If the auditor receives a technical report but does not agree with its recommendations, he will attempt to reconcile any disagreements with the engineering specialist who prepared the report and/or with the specialist's supervisor. If necessary, assistance to resolve the differences will be solicited from the contracting officer. If the auditor is unable to resolve the differences, he should not utilize the

technical report in developing the audit opinion or in determining the amount of the questioned costs. In such cases, however, the technical report will be attached to the audit report, which will include an explanation of the reason the auditor did not rely on the recommendations included in the technical report. The circumstances should be adequately described and the related audit conclusion appropriately qualified.

e. Auditors should be alert that FAR 15.805-5(d) and (e)(5) require that we notify contracting officers in writing when cost or pricing data provided are so deficient as to preclude a satisfactory review or when we encounter denial of access to data or records essential to performance of a satisfactory review. Written confirmation should include a description of the deficient or denied data or records; explanation why the denied data or records are needed; explanation of documentation or contractor action needed to correct deficient cost or pricing data; the amount of proposed cost considered unsupported because of the deficient data or the questioned costs resulting from denial of access to records; and the action taken by DCAA to obtain adequate cost or pricing data.

10-209.3 Summary of Audit Results (mandatory paragraph)

a. This section should summarize the results of audit, qualified as appropriate (9-209), and provide the auditor's conclusions, recommendations, overall opinion, and a summary of the contractor's reactions to the report findings. When applicable, refer to the exhibits, schedules, appendixes (10-214), or narrative paragraph of statement of conditions and recommendations (10-407) that contain the detailed results.

b. While it is acceptable in some limited situations to provide the complete results of audit in this paragraph (see 10-218), it is usually more appropriate to summarize the findings here and refer to details in an exhibit, schedule, etc. The report is usually easier for the recipient to read and use if the narrative portion of the report is introductory in nature with the detailed findings provided in the

exhibits, schedules, and appendixes as needed.

c. Since the content of this paragraph will vary depending on the type of report being prepared, refer to specific guidance contained in the applicable sections of this chapter.

d. State in this section the name and title of the contractor's designated representative with whom the exit conference was held (4-304). In most cases, detailed comments on the contractor's reaction to the report findings will be included elsewhere in the report, either in other parts of the narrative, or in exhibits, schedules, or appendixes. In those cases, a reference to that part of the report containing the contractor's reaction is sufficient. When a contractor provides a formal written response, it should be included as an attachment to the audit report. However, if convenient, the contractor's reaction can be included here.

e. In reports on price proposals, identify the designated representative with whom factual matters were discussed and the major areas of difference likely to be pursued at negotiations.

f. If information in the report was provided to the contracting officer in advance by telephone, a confirming statement will be made here identifying the information.

g. Include a cautionary note that information in the audit report should not be used for other purposes without first discussing its applicability with the auditor.

10-209.4 Disposition of Audit Results (mandatory paragraph)

The following standard comments should appear in the order indicated. Refer to the remaining sections in this chapter for additional comments that may be required in reports on specific areas.

a. Offer to provide accounting counsel and any additional audit assistance which the contracting officer (or other addressee) may require in finalizing the action or in implementing the report recommendations. Include the FAO telephone and fax numbers. Inform the contracting officer that further advice and assistance can be obtained by (1) tele-

phoning or submitting a request to the office issuing the report, or, when applicable, by (2) contacting the on-site procurement liaison auditor (include the PLA's name, telephone number, and office location as shown in 15-3S1). Depending on the type of report, complexity of the audit, and audit findings, recommend that the auditor be invited to attend the negotiation conference.

In a report on a price proposal review, add the following sentence after offering to provide additional audit service:

"Additional audit support should be requested if changed requirements or more current cost or pricing data have a significant impact on the proposal."

b. Mention any subsequent or supplemental reports you intend to issue pertaining to unresolved or qualified costs, if applicable. In most cases, inclusion of a "circumstances affecting the audit" paragraph (10-209.2) in the report should be followed up with a comment regarding the intent to supplement the report.

c. Include a request that the audit office be advised of the disposition of the audit recommendations, if appropriate. Also, if appropriate, include a request for comments and suggestions on the report and related audit support.

d. In functional/operational reviews and system surveys, express appreciation for the contractor's support and cooperation extended during the review, if appropriate.

e. If during any audit our effort was significantly reduced because of self-governance activities (e.g., CRAG, coordinated audits, etc.), express appreciation for the contractor's cooperation and support. Following is an example of such a paragraph:

"We wish to express our appreciation for the cooperation extended by ABC's internal audit department during our audit. The coordination of our audit effort with that of the internal auditors enabled us to complete our audit of relocation costs more efficiently."

f. In cases where a DCAA Summary Sheet is required (see 15-605), include the following statement:

"We have attached to the original report a Contract Audit Follow-up Summary Sheet in accordance with reissued DoD Directive 7640.2 dated 12 February 1988."

10-210 Signature Block

a. The report will be signed by the auditor authorized to do so by applicable DCAA letters delegating signatory authority; in most cases, the branch manager or resident auditor.

b. No "command" or authority line is used on audit reports. As shown in Figure 10-2-4, "DEFENSE CONTRACT AUDIT AGENCY" is typed at the right margin on the second line below the last line of the narrative. The first line of the signature block is typed on the fifth line below this line.

c. Joint reports prepared under a cost monitoring program will be signed by both the head of the local contract administration office and the cognizant auditor (10-410).

10-211 Report Distribution

a. Audit report recipients should be informed of all other recipients. The distribution list should properly identify each organization.

b. The report distribution is placed at the left margin on the second line below the signature block, as illustrated in Figure 10-2-4. Place long distribution lists on a separate sheet or sheets following the signature page.

c. Any special distribution requirements pertaining to certain types of reports will be stated in the following sections of this chapter. In addition to those requirements, provide the requested number of copies. For reports not in response to a specific request, furnish the addressee one copy with the original, unless other local working arrangements exist. Copies of subcontract incurred cost audits should be distributed to the DCAA office cognizant of the prime contractor. On the distribution list, the prime con-

tractor and contract number should be identified for easy routing. Also route copies to the regional office, as required.

d. Also see 15-100 for distribution requirements pertaining to non-DoD agencies.

10-212 Table of Contents

All audit reports containing more than one exhibit, schedule, or appendix (or any combination) will include a table of contents. It will be situated immediately following the introductory narrative section of the report (or after the distribution list if included on a separate page or pages). The format of a table of contents for a price proposal evaluation is illustrated in Figure 10-2-5.

10-213 Data Sheet

a. A data sheet is sometimes used as a convenient method of providing the report recipient with basic descriptive information concerning the submission being reviewed (see 10-305). Inclusion of a data sheet in a report is optional, since the information is usually provided in the report body. While its use is normally restricted to reports on contractor price proposals, it may in some cases also be useful in reports on postaward reviews, terminations, etc.

b. An example of a data sheet for an audit report on a price proposal is shown in Figure 10-3-1. The format would have to be altered for a postaward review, termination, etc. by providing descriptive data pertinent to the review being performed (e.g., type of contract, contract number, value, termination on inventory or total cost basis, etc.).

10-214 Exhibits, Schedules, and Appendixes

a. The audit report should contain exhibits and supporting schedules necessary for a clear and complete presentation of the audit results and recommendations. The exhibits, schedules, appendixes, and narrative body of the report should be cross-referenced where required. The words "exhibit," "schedule," and "appendix" should be written entire-

ly in upper case letters when they are used as titles (e. g., see Figure 10-3-2).

b. Designate principal tabulations "exhibits" and identify them by capital letters in consecutive order; e.g., EXHIBIT A, EXHIBIT B, etc. Additional tabulations needed to explain any of the items in the principal exhibits will be designated "schedules" and referenced by numbers preceded by the corresponding exhibit letter; e.g., SCHEDULE A-1, SCHEDULE A-2, etc. The content of the exhibits and schedules will vary depending on the type of audit report being prepared. Review the appropriate section of this chapter to identify any specific requirements for the type of audit report you are preparing.

c. The content of the appendixes will vary depending on the type of audit report being prepared. For example, in reports on price proposals, the appendixes serve to provide additional information necessary for a complete understanding of the contractor's proposal, such as the contractor's organization and operation, accounting system, comments on profit, other matters, etc. In reports on functional/operational reviews and system surveys (10-400), the appendixes are primarily reserved for detailed statements of conditions and recommendations, the contractor's written response, and the contractor's organization (10-413 and 10-414). Audit reports on annual indirect costs may include an appendix on billing rates; postaward review audit reports may include an appendix on "chronology of significant events" and may include comments on advance agreements or special contract provisions. Audit reports on equitable adjustment proposals and claims will also have an appendix on "chronology of significant events." Refer to the appropriate section in this chapter dealing with the specific type of report being prepared for further guidance.

d. Government technical reports and any assist audit reports from other DCAA locations will be attached as appendixes to the audit reports to which they apply.

e. Identify appendixes by numbers in consecutive order; e.g., APPENDIX 1, APPENDIX 2, etc.

10-215 DCAA Summary Sheet

If a DCAA Summary Sheet is required per DoD Directive 7640.2, Policy for Follow-up of Contract Audit Reports, it should be attached to the "original" of the audit report and sent to the contracting officer having negotiation or disposition authority. Detailed instructions regarding use and preparation of summary sheets are included in 15-605.

10-216 Supplemental Audit Reports

10-216.1 Criteria for Use

a. Government auditing standards provide for issuance of supplemental audit reports when the auditor subsequently becomes aware of information which, had it been known at the time the report was issued, would have affected the report conclusions (AICPA Auditing Standards Section 561).

b. A supplemental report generally changes the original report conclusions. A new report rather than a supplement should be issued when the purpose of the report differs from the purpose of the original report. This is the case when a special report is issued to summarize results of audit in previously issued reports or when a follow-up report is issued on a functional/operational review to determine if the contractor took adequate corrective action on reported findings.

c. Supplemental DCAA audit reports should be issued when:

(1) Insufficient time was provided to perform a complete audit (especially on major proposals, sensitive reviews, or where there is potential for significant audit findings), the requested due date extension was not granted, and a qualified report was issued advising that audit effort would be continuing (10-103.1c).

(2) Events occurring after report issuance have a material effect on government contract costs (10-103.3f).

(3) Required technical information is received after the technical report is issued and the results have a significant impact on the audit findings (10-304.2d(1)).

(4) Additional information is received which is necessary to reflect resolution of

unresolved costs contained in the audit report and the report will serve a useful purpose because contract negotiations have not been concluded (10-304.2d(2)).

(5) Additional supporting information is provided by a contractor during the negotiation conference which would affect the report conclusions. In this situation, the auditor should advise the contracting officer that, if negotiations are delayed to allow sufficient time for audit review, a supplemental report will be issued.

(Note that FAR 15.805-5(h) requires contracting officers to request that auditors immediately review significant information disclosed after submission of a cost proposal. Auditors should exercise care that any subsequent reviews must comply with government auditing standards, including adequate testing of evidential matter and appropriate supervisory review. If this cannot be accomplished, there should be no appearance of concurrence with the updated information or implied amendment of the audit report recommendations.)

(6) Additional information is received which would correct an error in the original report having a material effect on the report conclusions.

10-216.2 General Requirements

a. A supplemental report need not supersede the original audit report in its entirety. It can be limited to the affected item(s) of cost or other portions of the prior report and should not generally restate previous information or recommendations.

b. Make the task of supplementing as easy as possible for the report recipient(s). Rather than instructing the addressee to make numerous pen and ink changes and page substitutions, it is often easier to replace a complete exhibit or schedule in the original report with a revised exhibit or schedule.

c. If inserting a revised narrative, exhibit, etc. of more or fewer pages than the original would require the renumbering of the complete report, and it is not prudent to replace the original report in its entirety, it is acceptable to leave some pages blank or use decimals after the page numbers to keep the pages in sequence.

For example, assume that the original report exhibit covered pages 5 through 10 and schedule A-1 started on page 11:

(1) If the new exhibit is 8 pages long rather than the original 6, number the last two pages 10.1 and 10.2. No other changes to the original report need be made and schedule A-1 can still begin on page 11.

(2) If the revised exhibit was only 4 pages long rather than the original 6, the last two pages of the revision could include the following statement: "This page intentionally left blank." As in the example above, schedule A-1 would still start on page 11.

d. Dollars examined, questioned costs, unsupported costs, etc. initially reported will frequently require revision as a result of issuance of a supplemental audit report. As a result, performance data previously reported in the DCAA management information system should be revised as appropriate.

10-216.3 Supplemental Report Format

Major components of a supplemental report are listed below. Discussion of the particular elements is contained in the referenced paragraphs. Except where noted, the format and contents of the supplemental report must comply with the basic audit report requirements in 10-204. For example, requirements for an audit report cover would not change, distribution requirements remain the same, etc.

Audit Report Cover Sheet/Subject Element (10-216.4)

Report Narrative (10-216.5)

Purpose and Scope of Supplemental Audit

Circumstances Affecting the Supplemental Audit

Summary of Supplemental Audit Results

Disposition of Supplemental Audit Results

Table of Contents (10-216.6)

10-216.4 Audit Report Cover Sheet/Subject Element

a. The report cover sheet, letterhead page, and all supplemented pages should contain the original audit report number followed by the supplement number (e.g.,

S1, S2, etc.). If the original exhibit is to be replaced by a revised exhibit, all pages of the revised exhibit should show the supplement number.

b. The audit report cover sheet and subject should identify the audit report as a supplement; for example, "Supplement to Report on Audit of Proposal . . .". Otherwise, the cover sheet, subject, and addressee elements should be identical to the original report.

10-216.5 Report Narrative

The supplemental report can usually be limited to a narrative section setting forth the "purpose and scope of supplemental audit," "summary of supplemental audit results," and "disposition of supplemental audit results," together with the attached supplemental exhibits, schedules, or individual pages. Comments on these areas follow:

a. Purpose and Scope of Supplemental Audit

State the reason why the supplemental report is being issued. If applicable, mention whether the supplemental audit was limited to specific areas or items of cost. For example:

"This supplemental report incorporates the results of the government report of technical evaluation, which was not received in time to be included in our original audit report dated"

If there are any changes in the scope of audit statement as contained in the original report, make note of it in this paragraph. For example, a comment may be included that the scope of review qualification and "circumstances affecting the audit" paragraph in the original report no longer apply. In the "disposition of supplemental audit results" paragraph (refer to c. below), the auditor should advise the report recipient(s) to make a pen-and-ink change or page substitution reflecting this change.

b. Summary of Supplemental Audit Results

(1) This paragraph will state the net effect of the supplemental report and the primary reason(s) for the change. For example:

"As a result of the technical review, total questioned costs of \$ ____ in our original report are revised to \$ ____, primarily because of recommended reductions to proposed material quantities and manufacturing labor hours."

(2) If applicable, state the name and title of the contractor's designated representative with whom the supplemental results were discussed (10-209.3d).

c. Disposition of Supplemental Audit Results

In the first paragraph of this report element, provide precise instructions to enable the report recipient to incorporate the new pages, exhibits, etc. into a complete (revised) report.

(1) In the example in a. above, extensive changes would be required as a result of incorporating the results of technical review. The original scope of audit paragraph would probably require revision and the "circumstances affecting the audit" paragraph in the original report would have to be revised or eliminated in its entirety to delete the technical qualification; the summary of audit results paragraph would change to reflect the additional questioned costs and a change in the opinion paragraph; the disposition of audit results paragraph would change to eliminate the comment on the intention to supplement the report; the table of contents will change to show the technical report as an appendix; and the exhibit(s) and or schedule(s) in the original report would change. In this situation, this instruction paragraph would probably state the following:

"This supplemental report replaces our original report in its entirety."

(2) If the original report is not being entirely superseded, instruct the recipient to make pen-and-ink changes or page substitutions. For example:

"Remove pages 2, 4, 6, and 7 from our original report and replace with the attached revised pages. Also, renumber page. . . ."

In this case, add the following additional comment:

"Except as noted above, all other comments contained in the original report remain unchanged."

(3) Restate the offer to provide accounting counsel or any additional audit assistance which the contracting officer may require and provide the FAO telephone and fax numbers (10-209.4a).

10-216.6 Table of Contents

Provide a revised table of contents to the report recipients as required.

10-217 Report Transmittals and Routing

Report transmittals should not be used to convey information or comments that should be included in the report itself. For this reason, a transmittal memorandum or letter is not normally used for initial distribution of reports. However, it is acceptable to attach a transmittal letter to a report if it is helpful in highlighting an area for the contracting officer's consideration. A transmittal letter could also be used to explain special distribution to officials who seldom receive reports from the FAO. For example, if a report discloses that the contractor has been inappropriately paid progress payments in excess of \$500,000 under a contract administratively controlled by the Navy (see 14-206b), a routing slip to the Navy Director of banking and Contract Financing might state:

"In accordance with your standing request to DCAA Headquarters, the attached report is distributed to your office because the overpayment exceeds the designated reporting threshold."

10-218 Use of Short Form Audit Reports

The term "short form" report is often used to describe audit reports in which the results of audit are provided in the "summary of audit results" paragraph without any supporting exhibits, schedules, and, in many cases, appendixes.

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**1029
110-218a.**

a. If the complete results of audit can be conveniently provided in the "summary of audit results" paragraph, it is acceptable to do so (10-209.3a). However, this approach is acceptable only if the results can be confined to one or two typewritten pages. The preferable method is to keep the narrative portion of the report introductory in nature, with the detailed findings provided in the exhibits, schedules, and appendixes.

b. If an audit discloses no questioned costs, the report will probably not contain exhibits or schedules. In this situation, the "summary of audit results" paragraph will consist of a statement such as the following:

"Our audit disclosed no questioned, unsupported, or unresolved items

which would preclude acceptance of the contractor's proposal as submitted."

In this case, however, make sure that the report is responsive to the audit request and includes any other information as required, especially in areas of special emphasis. For example, the audit request may specify submission of a schedule of proposed and recommended labor and indirect expense rates applicable to the particular contractor submission under review. Preprinted appendixes covering the contractor's organization and operations, accounting system, profit, etc., should also be included as necessary to provide a comprehensive report.

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Figure 10-2-1

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Figure 10-2-1
SAMPLE COVER SHEET FOR A REPORT ON AUDIT OF A PRIME CONTRACT PROPOSAL

[Actual size is 8-1/2 x 11"]

AUDIT REPORT NO. _____

16 March 1992

**REPORT ON AUDIT OF PROPOSAL FOR
INITIAL PRICING
UNDER RFP NO. DLA600-92-R-0132
XYZ CORPORATION
PHILADELPHIA, PENNSYLVANIA**

The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of XYZ Corporation. [If appropriate add, "However, the government technical report included as Appendix 7 of our report should not be released to XYZ Corporation without the approval of DCMAO-Philadelphia."]**

Under the provisions of Title 32, Code of Federal Regulations, Part 290.26(b)(2), any Freedom of Information Act requests for audit reports received by DCAA will be referred to the cognizant contracting agency for determination as to releasability and a direct response to the requester.

Contractor information contained in this audit report may be proprietary. The restrictions of 18 U.S.C. 1905 should be considered before this information is released to the public.

This report may not be released to any Federal agency outside the Department of Defense without the approval of Headquarters, DCAA, except to an agency requesting the report in negotiating or administering its contract.

**MID-ATLANTIC REGION
PHILADELPHIA BRANCH OFFICE
DEFENSE CONTRACT AUDIT AGENCY
PHILADELPHIA, PENNSYLVANIA**

FOR OFFICIAL USE ONLY

- * Location of window in report cover (does not appear on cover sheet).
- ** Note that the first paragraph of this sample cover sheet is omitted on some reports, and modified for subcontract reports. See 10-206.1a.

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1031
Figure 10-2-2a

Figure 10-2-2a
SAMPLE COVER SHEET FOR A REPORT ON AUDIT OF A SUBCONTRACT PROPOSAL

[Actual size is 8-1/2 x 11"]

AUDIT REPORT NO. _____

16 March 1992

**REPORT ON AUDIT OF SUBCONTRACTOR
PROPOSAL
TO XYZ CORPORATION
UNDER CONTRACT NO. DLA600-87-R-0132
ABC CORPORATION
ALEXANDRIA, VIRGINIA**

The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of ABC Corporation. Nor does this Agency or ABC Corporation object to release of this report to authorized representatives of XYZ Company. See Appendix 6 for a copy of the subcontractor's release statement. [If appropriate add, "However, the government technical report included as Appendix 7 of our report should not be released to ABC Corporation without the approval of DCMAO-Alexandria."]

Under the provisions of Title 32, Code of Federal Regulations,

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Figure 10-2-2b

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Figure 10-2-2b
SAMPLE COVER SHEET FOR A REPORT ON SUBCONTRACT INCURRED COSTS

[Actual size is 8-1/2 x 11"]

AUDIT REPORT NO. _____

16 March 1992

*
REPORT ON FINAL AUDIT OF COSTS
INCURRED
SUBCONTRACT ISSUED BY XYZ CO.
UNDER CONTRACT NO. DLA600-87-C-0132
ABC CORPORATION
ALEXANDRIA, VIRGINIA

ABC Corporation objects to release of this report to the higher-tier contractor, XYZ Co., because these two companies frequently compete for prime contracts**

- * Location of window in report cover (not actually marked on cover sheet).
- ** Note that the first paragraph of the cover sheet varies if the subcontractor objects to release of the report to the higher-tier contractor. See 10-206.3.

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Figure 10-2-3

Figure 10-2-3
AUDIT REPORT SUBJECT AND ADDRESS FORMATS

[Actual size is 8-1/2 x 11"]

DISTRICT BRANCH OFFICE
DEFENSE CONTRACT AUDIT AGENCY
8181 PROFESSIONAL PLACE, SUITE 101
LANDOVER, MARYLAND 20785

Audit Report No. _____

16 March 1992

SUBJECT: Report on Audit of Proposal for Initial Pricing
Under RFP No. DLA600-87-R-0132
Beta Division
ABC Chemical Corp
College Park, Maryland 20910

TO: Procuring Contracting Officer (Room 8E704)
Defense Fuel Supply
Center Alexandria, Virginia 22204

THRU: Administrative Contracting Officer (Code 6-C)
Defense Contract Management District Mid Atlantic
Philadelphia, Pennsylvania 19115

1. Purpose and Scope of Audit

a. As requested by DCMDM in letter DC-123, dated 25 February 1992, we have audited Beta Division's proposal for \$800,000. This firm-fixed-price proposal . . .

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Figure 10-2-4

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Figure 10-2-4

AUDIT REPORT SIGNATURE ELEMENT AND SAMPLE DISTRIBUTION LIST

b. As required by FAR 15.808(b), please furnish us a copy of the price negotiation memorandum at the conclusion of the negotiations. Please advise us if no award is made. We also invite your comments and suggestions on this report and related audit support.

DEFENSE CONTRACT AUDIT AGENCY

Mary C. Stumm, Branch Manager

Copy furnished:

PCO, [insert PCO organization identification] (Advance Copy)
DCAA Liaison Auditor, [insert PLA organization identification]

[Actual size is 8-1/2 x 11"]

Note that the last sentence of a report, and the distribution list, vary according to the type of audit. Also, a long distribution list may be placed on the following page of the report.

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Figure 10-2-5

Figure 10-2-5
FORMAT FOR TABLE OF CONTENTS

Audit Report No. _____

XYZ Corporation
Anytown, Arizona

TABLE OF CONTENTS

Page

Report Narrative	
Data Sheet	
Statement of Contractor's Proposal and Results of Audit	EXHIBIT A
Analysis of Engineering Staff-Month Factor	SCHEDULE A-1
Computation of Auditor's Projected Indirect Cost Rates	SCHEDULE A-2
Basis of Contractor's Proposal	APPENDIX 1
Outstanding Estimating Deficiencies	APPENDIX 2
Contractor's Organization and Operations	APPENDIX 3
Contractor's Accounting System	APPENDIX 4
Other Matters to be Reported	APPENDIX 5
Comments on Profit	APPENDIX 6
Individuals Having Access to Proprietary or Source Selection Information	APPENDIX 7
Government Technical Report	APPENDIX 8

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10-300 Section 3 — Audit Reports on Price Proposals

10-301 Introduction

a. This section presents guidance for preparing and distributing audit reports on (1) audits of estimated costs and profit under price proposals for all types of negotiated contracts and modifications, and (2) audits of incurred costs under repricing proposals for incentive and price redeterminable fixed-price contracts. The term "contract" includes sub-contract and "contracting officer" includes designated representatives.

b. Guidance on audit reports related to contract claims is in 10-1100.

10-302 Format and Content of Reports

a. General report requirements are set forth in 10-200. The report should contain the necessary and pertinent information disclosed by the audit which will assist the contracting officer in negotiating with the contractor.

b. A short form report may be used when the audit discloses few, if any, questioned, unsupported, or unresolved items (see 10-218). In situations where this type of report is used, make sure the report is responsive to the audit request. Include comments covering areas of the contractor's proposal where the PCO/ACO requested special emphasis. A short form report may be limited to a cover sheet, brief statements concerning the purpose, scope, results of audit (including an opinion statement set forth in 10-304.3c), and disposition of audit results. To illustrate, except when a short form report is used with an adverse opinion (10-304.3c(10), (11), or (12)), the results of audit paragraph might begin with the following statement:

"Our audit disclosed no questioned, unsupported, or unresolved items which would preclude acceptance of the contractor's proposal as submitted."

c. In a short form report with an adverse opinion but substantially no questioned, unsupported, or unresolved

items to be disclosed, begin the summary of audit results paragraph with one of the adverse opinion statements set forth in 10-304.3c(10), (11), or (12), followed with an appropriate results statement, such as:

"Our audit disclosed no additional exceptions or deficiencies."

d. When the report is being submitted to a buying office for which the auditor has never provided, or seldom provides, audit services, it should also include, as needed: (1) appendixes concerning the contractor's organization and operations, accounting system deficiencies, and profit pattern, and (2) any other information concerning the proposal that may be valuable to the contracting officer during negotiations.

10-303 Addressing and Distributing Reports on Price Proposal Audits

10-303.1 Reports on Prime Contract Proposals

a. Reports on price proposal audits will usually be addressed to the PCO or to the plant representative/ACO acting as a PCO. (See 10-208 for general policy.) However, requests may be received from the plant representative/ACO without receiving the auditor's copy of the PCO's request for field pricing support as required by DFARS 215.805-5(a)(1)(A). If there is doubt about the correct addressee, ask the plant representative/ACO if she or he has been delegated procurement authority to execute the contract pricing action involved.

b. If the report is addressed to the PCO (other than the plant representative/ACO acting as a PCO), and DoD field pricing support procedures apply (9-102.1), provide the original copy of the report to the plant representative/ACO for transmittal to the PCO per FAR 15.805-5(g). "Through" addressing may be used for this purpose (see 10-208.4).

c. If "through" addressing is used, provide an advance copy of the report to the PCO. A routing slip may be used for this purpose. In such cases, the audit

report distribution list (10-211) should identify this advance distribution to the PCO.

d. Include the appropriate PLA (refer to 15-3S1), and NASA OIG Center Director (see 15-1S1), when applicable, on the distribution list for each prime contract price proposal audit report.

10-303.2 Reports on Intracompany and Subcontract Proposals

a. If field pricing support procedures apply (9-100 and FAR 15.805-5/DFARS 215.805.5), an audit report of an intracompany or subcontractor proposal will be addressed to the plant representative/ACO responsible for the segment or subcontractor submitting the proposal. Added distribution requirements include: (1) a minimum of two copies for the addressee (including one for transmittal through plant representative/ACO channels to the plant representative/ACO at the prime contract level) and (2) a copy directly to the prime contract auditor. Note that the assist audit report should still be addressed and distributed in the above manner even if (i) the assist audit was requested by DCAA, (ii) the ACO/PCO did not agree with the request, or (iii) the original copy of the request was not furnished to the assist auditor through ACO channels (see 9-104.2 and 9-104.4).

b. A proposal audit may also be made for direct assistance to the contract auditor at the prime level, as in the case of certain non-DoD pricing cases, on audits of foreign direct sales proposals, or as part of the audit of costs incurred under cost reimbursement or redeterminable type prime contracts. Address reports on these audits to the requesting PCO. Provide a copy to the plant representative/ACO responsible for the audited segment or subcontractor, unless he or she expressly prefers not to receive copies of such reports.

10-304 Narrative

10-304.1 Purpose and Scope of Audit

a. This section will refer to the audit request and state the nature and amount of the pricing action. The report caption

for an evaluation of agreed-upon procedures should be "Purpose and Scope of Agreed-Upon Procedure." The following opening statements should be modified if additional cost or pricing data submissions were audited or due date extensions were requested. (See 10-209.1 and FAR 15.805-5(e).) Opening statements for four common situations could read as follows:

(1) Standard Audit Request

"As requested by DCM AO-Alexandria in memorandum DC-123 dated 25 September 1992, we have audited ABC Company's proposal, dated 15 September 1992 for \$800,000. This firm-fixed-price proposal provides for 50 widgets and was submitted in response to RFP No. NA 1-101. The proposed performance period is 1 November 1992 through 30 June 1993."

"The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our audit."

(2) Later Proposal Audited

"As requested by DCM AO-Alexandria in memorandum DC-123 dated 25 September 1992, we have audited ABC Company's firm-fixed-price proposal for 50 widgets, submitted in response to RFP No. NA 1-101. Our report addresses ABC Company's revised proposal dated 1 October 1992 for \$850,000 in lieu of the 15 September 1992 proposal referenced in the audit request. The proposed performance period is 1 November 1992 through 30 June 1993."

"The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our audit."

(3) Specified Cost Element Audited (see 9-108)

"As requested by DCM AO-Alexandria in memorandum DC-123 dated 25 September 1992, we have audited the direct material cost portion

10-304.1a.

(\$200,000) of ABC Company's firm-fixed-price proposal dated 15 September 1992, for \$800,000. The proposal provides for 50 widgets and was submitted in response to RFP No. NA 1-101. The proposed performance period is 1 November 1992 through 30 June 1993."

"The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposed direct material costs based on our audit."

(4) Agreed-upon Procedures Applied (see 9-108) (note: Use "Purpose and Scope of Agreed-Upon Procedures" as section heading)

"As requested by DCMAO-Alexandria in memorandum DC-123 dated 25 September 1992, we have applied the verification procedures specified in your request to the direct labor cost portion of ABC Company's firm-fixed-price proposal, dated 15 September 1992, for \$800,000. This proposal provides for 50 widgets and was submitted in response to RFP No. NA 1-101. The proposed performance period is 1 November 1992 through 30 June 1993."

"The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to apply the procedures discussed above to the contractor's proposal."

b. Except for audits of part of a proposal, include the following scope of audit statement, modified as shown where appropriate:

"Except as discussed in paragraph 2 [omit if no 'circumstances affecting the audit' paragraph is included in the report or if the circumstances described do not have an adverse bearing on the auditor's conformance with auditing standards], we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance

about whether the proposal is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the proposal. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall proposal presentation. The cost or pricing data requirements and cost principles contained in the Federal Acquisition Regulation (FAR) and DoD FAR Supplement (DFARS) [for non-DoD agencies, identify specific agency supplement - see 15-102.2] and the practices required by applicable Cost Accounting Standards [omit the preceding nine words from the report if the contract based on the proposal will not be CAS-covered] were used as criteria in evaluating the proposed costs. We believe that our audit provides a reasonable basis for our opinion."

c. Scope statements such as the following will be used for audits of part of a proposal. See 10-209.1c for additional statements pertaining to technical reports and contractor CAS status that should be attached to the end of the following scope statements when appropriate.

(1) Specified Cost Element

"As requested, our audit was limited to an examination of the proposed direct material and direct labor costs. Except as discussed in paragraph 2 [omit if no 'circumstances affecting the audit' paragraph is included in the report or if the circumstances described do not have an adverse bearing on the auditor's conformance with auditing standards], we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the cost elements audited are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures for the cost elements

audited. An audit also includes assessing the accounting principles used and significant estimates made by the contractor in developing the proposed amounts for the cost elements audited as well as evaluating the overall presentation for those costs. The cost or pricing data requirements and cost principles contained in the Federal Acquisition Regulation (FAR) and DoD FAR Supplement (DFARS) [for non-DoD agencies, identify specific agency supplement - see 15-102.2] and the practices required by applicable Cost Accounting Standards [omit the preceding nine words for proposals applicable to non-CAS-covered contracts] were used as criteria in evaluating the proposed direct material and direct labor costs. We believe that our audit provides a reasonable basis for our opinion."

(2) Agreed-upon Procedures

"As requested, our evaluation was limited to the application of [describe the procedures applied and the cost element(s) to which they pertain]. We did not perform the customary auditing procedures necessary to constitute an examination made in accordance with generally accepted government auditing standards."

10-304.2 Circumstances Affecting the Audit

a. If special circumstances have a significant adverse effect on the conduct of the audit or the application of the agreed-upon procedures or its results, briefly identify each circumstance or condition. Specifically reference the report exhibit, schedule, or appendix paragraph which contains the detailed discussion on the item involved. Examples of items to be noted in this paragraph include: (1) lack of access to contractor records, including budgetary data (see 1-504 for guidance on access to records); (2) time limitations on the scope of audit; (3) failure to obtain the results of a requested assist audit or technical analysis; (4) estimating system deficiencies that result in either signifi-

cant unsupported costs or an estimate which is not current, accurate, and complete; (5) significant instances of CAS or FAR noncompliance; (6) deficiencies which render the accounting system inadequate for the contract type proposed; and (7) uncompleted historical cost audits for prior years when a valid forward pricing rate agreement or other acceptable methods of evaluating proposed indirect costing rates are not available.

b. If the contractor has denied access to records or other pertinent data, identify the records to which access has been denied and describe the resulting restrictions or limitations on the scope of the audit. (See FAR 15.805-5(d).) Illustrative statements describing an access to records problem and a contractor's failure to prepare budgetary forecasts follow:

"We were denied access to time cards, which, in our opinion, are required to adequately evaluate the direct labor cost included in the proposal. We discussed this condition with Mr. R. Smith, ABC Company's Controller, on 1 October 1989 and notified Mr. J. Jones, ACO, of the denial of access by telephone and memorandum on 2 October. See Appendix 5 for further discussion. We were unable to evaluate this cost by other audit procedures. Therefore, the audit results are qualified to the extent that an audit of the records denied may disclose additional questioned costs."

"The contractor has not prepared budgetary forecasts for the entire proposed period of contract performance. [Briefly explain what cost elements and period are not covered.] In our opinion, comprehensive budgetary data are required to facilitate the preparation of reliable cost estimates and as a basis for financial control over costs during contract performance. We were unable to determine by other audit procedures the possible impact that budgetary data would have on the proposed direct costs, indirect expense rates, and related allocation

bases. Our opinion regarding these costs is therefore qualified."

c. When the scope of audit is limited because of insufficient time, clearly indicate those areas in which an audit was not accomplished. State if additional time was requested but not granted, or granted only in part. In those circumstances where it is appropriate to continue the audit after issuance of the report, follow the procedure detailed in 10-103.1c. An example of a statement to be included in this situation follows:

"We were unable to complete our audit of labor cost because of time limitations. [Briefly explain the reasons why time was insufficient.] An extension of the audit report due date was requested from Col. R. Jones on 10 October 1988 but was not granted. [Briefly explain why the extension was not granted.] Therefore, the audit results are qualified to the extent that an audit of labor cost may disclose additional questioned costs. See Exhibit A, Note 5, for further discussion."

d. If a requested technical or assist audit report is not received in time to be incorporated into the audit report, state that fact and, if known, the reasons for nonreceipt.

(1) Nonreceipt of technical input. Provide a brief comment on the follow-up action taken to obtain the required technical information or report. State whether the technical review will be performed and identify the organization responsible for performing it. Also provide a brief comment on the status of the technical review, if any, and on any future reporting action contemplated after receipt of the report. If the required technical information is received after the audit report has been issued, prepare a supplemental report if it would serve a useful purpose at negotiations. (Further guidance on reporting the use of technical specialist assistance is provided in D-301. Detailed examples of report qualification statements are presented in D-302.)

(2) Nonreceipt of Assist Audit Report. An example of a statement that could be

used when waiting for an assist audit report follows:

"A review of available documentation in the contractor's files applicable to proposed subcontract costs showed that an audit evaluation by another DCAA office is needed to reach a definitive conclusion regarding the acceptability of the proposed subcontract costs. We requested an assist audit from our DCAA Resident Office at ABC Corporation. However, the results were not received in time for incorporation into this report. We anticipate receipt of the assist audit report on or about 15 October 1989. An extension of our audit report due date was requested from Col. R. Jones on 10 October 1989 but was not granted. [Briefly explain reasons why not granted]. The results of the assist audit are considered essential to the conclusion of this audit. Therefore, the audit results are qualified to the extent that additional costs may be questioned based on the results of the assist audit of proposed subcontract costs. See Exhibit A, Note 7, for further discussion. Upon receipt of the assist audit report, we will provide a supplemental report if contract negotiations have not been concluded and the supplemental report would serve a useful purpose."

This example assumes that the results of the assist audit are considered essential and that the summary of audit results will recommend that negotiations not be held until the assist audit results are considered. For assist audits not considered essential, the sentence "The results of the assist audit are considered essential to the conclusion of this audit" should be deleted from the above.

e. If estimating deficiencies discovered during the audit of a proposal result in either significant unsupported costs or an estimate which is not current, accurate, and complete, provide a brief explanation of the deficient condition and the specific action required to correct it. (See 5-1212b for specific action required when significant estimating deficiencies are

discovered as a result of price proposal and postaward audits, as well as estimating system surveys and follow-ups.) A detailed discussion of the deficient condition should be provided in the Basis of Contractor's Proposal appendix (10-307.1) of the report. If the condition had been reported previously, the circumstances should be described in the Outstanding Estimating Deficiencies appendix (10-307.2). DFARS 215.811-70(g) requires that once a significant estimating system deficiency is cited as a result of the estimating system survey, subsequent field pricing reports for each of that contractor's proposals reviewed will mention the outstanding deficiency until it is resolved. The cost impact of the deficiency should also be disclosed whenever possible.

(1) An example of a statement covering an estimating deficiency discovered during the audit of a price proposal follows:

"We consider the procedure by which the contractor estimated the proposed direct labor cost to be unacceptable because the proposed hourly rates include unreasonable and unsupported increases for wage escalations. To correct the deficiency cited, the contractor must develop new labor rates commensurate with the most recent union contract. A detailed discussion of the circumstances is presented in Appendix 3, Basis of Contractor's Proposal."

(2) If the estimating deficiency had been previously identified and reported, but not yet resolved, a statement such as the following should be inserted into the proposal audit report:

"We reported estimating deficiencies at PDQ Company in Audit Report No. 1234-0A240001, dated 15 January 1990. Some of these deficiencies remain uncorrected (see Appendix 4, Outstanding Estimating Deficiencies). The deficiencies affecting the subject proposal, and their impact, are described in Exhibit A, Notes 5 and 6."

f. If recommendations have been made to disapprove the estimating system in

whole or part, subsequent proposal audit reports should disclose these recommendations until the system is corrected (see 5-1212b).

g. If significant instances of CAS and FAR noncompliance have a significant adverse effect on the evaluation or the audit results, state this and define the specific corrective action the contractor needs to take. A detailed discussion of the deficient condition should be provided in the Contractor's Accounting System appendix (10-307.4).

h. If the contractor's accounting system is inadequate to determine the costs under the contract type proposed, state this and identify the contractor action required to make the accounting system adequate.

i. If the only effective method available to the auditor for evaluating proposed indirect forward pricing rates requires reliance on the results of historical overhead audits for prior years, and such historical audits are not reasonably current, the circumstances should be described and the potential effect on the audit conclusions defined (see 9-702.2).

10-304.3 Summary of Audit Results

a. The report section for an evaluation of agreed-upon procedures should be "Summary of Results of Agreed-Upon Procedures."

b. Except when a short form report is appropriate (see 10-218 and 10-302b), begin this paragraph with a summary statement of the amount(s) questioned, unsupported, or unresolved in relation to the amount proposed. In addition, describe the major components of the questioned costs wherever possible. For example, the statement might read:

"We have questioned \$1,614,712 of the \$23,676,000 proposed. Of this questioned amount, \$1,437,500 is direct material cost and related overhead. In addition, we consider \$765,000 to be unsupported, consisting primarily of scrap cost. Finally, we have classified \$1,456,123 as unresolved cost because the requested assist audit report on proposed subcontract cost has not been received. (See paragraph 2 above and Exhibit

710-304.3a.

A, Notes 4 and 5, for further comments on the unsupported and unresolved costs.) The detailed conclusions and recommendations resulting from our audit are presented in the exhibit(s) and appendixes of this report."

c. If an audit of specified cost elements or application of agreed-upon procedures is accomplished (9-108), then "proposed" in the first sentence of the preceding paragraph must be changed to "proposed for the cost elements audited" or "proposed for the cost elements evaluated through application of the procedures previously agreed upon." For example, a summary of audit results paragraph for a review of specified cost elements may read: "We have questioned \$100,000 of the \$1,000,000 proposed for the direct material costs audited." An example of a summary of audit results paragraph for application of agreed-upon procedures is: "The verification procedures discussed in paragraph 1 disclosed that the proposed direct labor rates are overstated resulting in a total overstatement of direct labor costs of \$250,000."

d. Reporting standards (see Chapter 2) require that we express an opinion on the adequacy of submitted cost or pricing

data and compliance of the proposal with FAR and, when CASB regulations apply, with Cost Accounting Standards. See paragraphs d and e below for guidance on opinion paragraphs for specified cost element reviews and application of agreed-upon procedures.

The cost or pricing data may be completely acceptable, generally acceptable except for some specific deficiency, or unacceptable (see 9-200). Additionally, the proposal may be in various degrees of compliance with promulgated Cost Accounting Standards or FAR. An appropriate combined opinion on the adequacy of the cost or pricing data and compliance with CAS and FAR can be prepared by using the following table and the statements presented in the subsequent paragraphs. To use the table, read down and across under the appropriate categories for adequacy and compliance. The numbers where the lines intersect represent the corresponding numbers of the sentences following the table which are to be combined in the order shown to present a complete opinion statement for the report. Minor changes in wording, such as references to proper exhibit or paragraph, should be made to fit each specific report.

		Cost or Pricing Data Adequacy		
FAR/CAS Noncompliance	Adequate	Inadequate In Some Respects	Not Adequate Contractor's Fault	Not Adequate and Access to Data Denied
	(9-209.1)	(9-209.2)	(9-209.3)	(9-209.3)
No Instances	1,5,9 (1,5,12)*	2,5,9 (2,5,12)*	5,3,11	5,4,11
Insignificant Instances	1,7,9 (1,7,12)*	2,7,9 (2,7,12)*	6,3,11	6,4,11
Significant Instances	1,8,10	2,8,11	8,3,11	8,4,11

* Use paragraph 12 if the auditor recommends price negotiations not be concluded for a reason not resulting from the contractor's action or inaction (see 9-209.3c). If significant noncompliances or inadequate cost or pricing data are encountered, an appropriate combination ending with paragraph 10 or 11 should be selected.

The following sentences comment on the adequacy of the cost or pricing data and the degree of compliance of the

proposal with CAS and FAR and provide a summary opinion statement on these issues.

(1) "In our opinion, the offeror has submitted adequate cost or pricing data."

(2) "In our opinion, the cost or pricing data submitted by the offeror are inadequate in some respects." (see comments on _____, Exhibit _____, Note _____).

(3) "In our opinion, the cost or pricing data submitted by the offeror are not adequate (see comments on _____, Exhibit _____, Note _____)."

(4) "In our opinion, the cost or pricing data submitted by the offeror are not adequate (see comments on _____, Exhibit _____, Note _____). In addition, the offeror denied access to data needed to evaluate the proposal, as described in paragraph 2 above." [Before this paragraph is used in the report, (a) it should be cleared with the regional office, (b) the ACO and PCO should be advised, and (c) the contractor should be informed of its content. Identify the specific data denied and explain why it is needed (see 9-205).]

(5) "The proposal was prepared in accordance with [if CAS covered, add "applicable Cost Accounting Standards and"] appropriate provisions of FAR" [if an agency supplement to FAR applies (9-102.2 and 15-102.2), add "and the (name the agency) Supplement"].

(6) "The proposal was not prepared in all respects in accordance with [if CAS covered, add "applicable Cost Accounting Standards and"] appropriate provisions of FAR" [if an agency supplement to FAR applies (9-102.2 and 15-102.2), add "and the (name the agency) Supplement"].

(7) "The proposal was not prepared in all respects in accordance with [if CAS covered, add "applicable Cost Accounting Standards and"] appropriate provisions of FAR [if an agency supplement to FAR applies (9-102.2 and 15-102.2), add "and the (name the agency) Supplement"] (see comments on _____, Exhibit _____, Note _____). However, the impact of the inadequacies and noncompliances described is considered to be relatively insignificant."

(8) "The proposal was not prepared in accordance with [if CAS covered, add "applicable Cost Accounting Standards and"] appropriate provisions of FAR [if an agency supplement to FAR applies (9-

102.2 and 15-102.2), add "and the (name the agency) Supplement"] (see comments on _____, Exhibit _____, Note _____).

(9) "Therefore, we consider the proposal to be acceptable as a basis for negotiation of a fair and reasonable price. This statement should not be interpreted to mean that the data are necessarily accurate, complete, and current in accordance with 10 U.S.C. 2306a (if a DoD, NASA, or Coast Guard proposal or 41 U.S.C. 254(d) for all others), since a postaward audit may disclose evidence not now discernible." [If CAS covered, add: "Nor should the statement be interpreted to mean that the offeror is necessarily in compliance in all respects with applicable Cost Accounting Standards, since a final recommendation cannot be made in a preaward evaluation. Instances of non-compliance with Cost Accounting Standards may be reported during contract performance."]

(10) "Therefore, we do not consider the proposal to be acceptable as a basis for negotiation of a fair and reasonable price, as discussed with [contracting officer or representative] by [auditor] of our office on [date] and as confirmed in our [memorandum/letter] to you dated [date]. At your request, we have, nevertheless, evaluated the proposal to the extent possible in the circumstances."

(11) "Therefore, we do not consider the proposal to be acceptable as a basis for negotiation of a fair and reasonable price, as discussed with [contracting officer or representative] by [auditor] of our office on [date] and as confirmed in our [memorandum/letter] to you dated [date]. To make the cost or pricing data adequate, the offeror must [insert offeror actions needed to resolve the noted inadequacies/deficiencies]. At your request, we have, nevertheless, evaluated the proposal to the extent possible in the circumstances."

(12) "Nevertheless, in our opinion the [name the item(s) considered essential] discussed in paragraph 2 above [is/are] significant enough to materially impact the results of the audit. Therefore, as discussed with [contracting officer or representative name and title] by [auditor] on [date], we recommend that con-

tract price negotiations not be concluded until the results of [item(s) needed] are considered by the contracting officer."

e. As with other portions of the narrative, if an audit of specified cost elements is being accomplished, the wording in the foregoing examples must be modified to address only the elements audited. For example, in a report on audit of specified cost elements, subparagraph (2) above could be modified to:

"In our opinion, the cost or pricing data submitted by the offeror in support of [insert the names of the cost elements audited] are inadequate in some respects."

f. For agreed-upon procedures reviews, if the application of the procedures disclosed no significant inadequate cost or pricing data or no significant noncompliances with FAR and/or CAS, the report should disclaim an opinion. An example follows:

"This report pertains only to the performance of the agreed-upon procedures discussed in paragraph 1. Because these procedures do not constitute an audit conducted in accordance with generally accepted government auditing standards, we do not express an overall opinion on the adequacy and compliance of the submitted cost or pricing data. In connection with the application of these procedures, no matters came to our attention that caused us to believe there were significant inadequacies or noncompliances related to the areas reviewed."

When the application of agreed-upon procedures discloses significant inadequate cost or pricing data and/or significant noncompliances with FAR and/or CAS, an adverse opinion will be issued. This opinion should be developed using the paragraphs referred to in c above for cost or pricing data not adequate—contractor's fault and significant instances of FAR/CAS noncompliance.

g. Also see 10-209.3 for other requirements related to this portion of the report narrative.

10-304.4 Disposition of Audit Results

a. Offer to provide accounting counsel and any additional audit service which the contracting officer may require in advance of or during the negotiation, together with the FAO's telephone and fax numbers. The following sentence should then be inserted:

"Additional audit support should be requested if changed requirements or more current cost or pricing data have a significant impact on the proposal."

Inform the contracting officer that further advice and assistance can be obtained (1) by telephoning or submitting a request to the office issuing the report, or (2), when applicable, by contacting the on-site procurement liaison auditor (include the PLA's name, telephone number, and office location as shown in 15-3S1). If the audit report is at the prime contract level, and the proposal and/or the audit conclusion are sufficiently complex to warrant audit assistance at negotiation, recommend that the auditor be invited to attend the negotiation conference.

b. Mention here any subsequent or supplemental reports you intend to issue pertaining to unsupported, unresolved, or qualified costs, per 10-216, 10-304.2d, 10-308.3, and 10-308.5d.

c. Include in this section any requests for feedback from the report addressee. For example, a report on an initial prime contract pricing proposal to be negotiated under FAR provisions might state:

"As required by FAR 15.808(b), please furnish us a copy of the price negotiation memorandum at the conclusion of the negotiations. Please advise if no award is made. We also invite your comments and suggestions on this report and our related audit support."

In reports that contain an adverse opinion (10-304.3c(10) or (11)) or a recommendation that negotiations be delayed until some unresolved or unsupported aspect is considered (10-304.3c(12)), modify this paragraph as follows:

"If an award must be made because of the urgency of the contracting requirement, please furnish us a record of the negotiations as required by FAR 15.808(b). Please advise if no award is made. We also invite your comments and suggestions on this report and our related audit support."

Omit reference in this paragraph to an "award" in reports on change order and price redetermination proposals. Likewise, omit any FAR citation from paragraphs requesting price negotiation memorandums in reports on subcontract or intracompany proposals. In most cases, it may be unrealistic for a subcontract auditor to expect feedback from the report addressee concerning award or nonaward of a subcontract proposed by the prime contractor. This information will usually have to be handled through contract audit channels.

d. In cases where a DCAA Summary Sheet is required (see 15-605), include the following statement:

"We have attached to the original copy of this report a Contract Audit Follow-up Summary Sheet in accordance with reissued DoD Directive 7604.2 dated 12 February 1988."

10-305 Data Sheet

a. An example of a data sheet format is illustrated in Figure 10-3-1. If a data sheet is included in the report, it will follow the signature page or the table of contents, if any (see 10-212).

b. The purpose of a data sheet is to reduce report preparation effort by furnishing basic descriptive information concerning the proposal being audited. Its use will therefore depend upon whether it adds to the overall quality of the report. Options to be considered by the FAO include providing this information in paragraphs of the report body or variations in the data sheet arrangements to reduce the effort required.

10-306 Exhibits and Schedules

a. The audit report should contain exhibits and supporting schedules re-

quired for a clear and complete presentation of the audit results and recommendations on all items in the contractor's proposal. The exhibits, schedules, and, where appropriate, the narrative body of the report should be cross-referenced.

b. Report exhibits and schedules for reviews of specified cost elements and application of agreed-upon procedures should only include the cost elements reviewed.

c. Furnish the contracting officer enough information so that the basis of the amounts proposed, the scope of audit, and audit recommendations for each cost element can be clearly understood. See 10-308 for further guidance on the adequacy of report disclosure.

10-307 Appendixes

a. As described in the following subparagraphs, appendixes may be used to provide other information when needed. However, when you issue recurring reports to the same addressee concerning the same contractor, consider reducing the need for appendix material by using one or more of the following options:

(1) Appendix information which the addressee is known to understand (e.g., the contractor's organization and operations) need not be repeated in each report unless the information includes audit exceptions.

(2) The amount of explanatory detail provided may be reduced by referring to recent prior reports, but only if it is known that the addressee is fully aware of the situation.

(3) Appendix information may be included in the narrative body of the report, exhibits, and/or schedules if so doing will improve report presentation of a particular matter. For example, deficiencies in the contractor's accounting system or internal controls which are directly related to questioned cost for an element of the proposal could be explained in the applicable note rather than referring to an appendix.

b. Appendixes (numbered per 10-214) should be combined on as few pages as practical. Appendixes need not be presented in the sequence discussed below except that field technical reports, if

¶10-307b.

applicable (see 10-307.9), should be the last appendix.

10-307.1 Appendix — Basis of Contractor's Proposal

Since the Standard Form 1411 requires the contractor to explain the basis of the proposal, use this appendix only when taking exception to the contractor's explanation. Any amplification of the contractor's explanation considered necessary should be included in the exhibit explanatory notes (see 10-306b). Describe any departure from the contractor's established estimating or accounting policies and practices.

10-307.2 Appendix — Outstanding Estimating Deficiencies

Use this appendix to list all open deficiencies in the contractor's estimating system. Deficiencies which were previously reported (see 5-1200 and 10-304.2e) but not corrected, should be discussed in detail in this appendix. This appendix should be continually updated for the addition of new deficiencies (flash reports) and the removal of corrected deficiencies. There should be sufficient explanation for the reader to understand each deficiency. The explanatory notes to the audit report should describe the cost impact of those estimating deficiencies which affect the price proposal. In addition, the current status of the contractor's corrective action should also be shown.

10-307.3 Appendix — Contractor's Organization and Operations

Information on contractor facilities, operating practices, principal products, intercompany relationships and affiliations with other companies, percentage of total sales derived from government business, etc., should be included to the extent pertinent to the audit and the negotiation. In presenting this information, consider its significance and the nature of the contractor's proposal.

10-307.4 Appendix — Contractor's Accounting System

a. Identify and briefly describe the contractor's cost accounting system. Report deficiencies in the contractor's accounting system and internal controls

which affect the reliability of contract cost. If the description of the system or existing deficiencies has been previously reported, so state.

b. Include an explanation if the contractor's accounting system is not adequate to determine the costs under the type of contract awarded or anticipated to be issued.

c. Some contractors regularly submit initial pricing proposals for production contracts which can be most effectively evaluated through learning or improvement curve techniques. If the contractor's accounting system does not provide for costing by lots, batches, or runs so that these techniques can be used, comment on this condition and recommend corrective action.

d. If the contractor has submitted an adequate disclosure statement under CAS regulations and the report recipient has received a copy, this appendix may not be necessary unless there are deficiencies.

10-307.5 Appendix — Other Matters To Be Reported

a. Use this appendix, if needed, to furnish information which cannot be conveniently shown in the exhibits and schedules and to present any other financial management matters related to the proposal which should be brought to the attention of the contracting officer.

b. If an audit of the contractor's proposal indicates that the contemplated contract type would not be in the best interest of the government, consider recommending a different contract type.

c. Furnish information to the procuring activity in all observed instances where the contractor is either (1) selling the same or similar items at lower prices to other customers (see 6-313) or (2) buying items from vendors who would sell directly to the government at a lower cost. The information provided should include the name of the other procuring activity, other prime contractor or vendor, the date of procurement, the contract or purchase order number, quantities procured, and the prices paid. Cost data for other procurements, if appropriate, may be included.

d. The following text should be included in the appendix when the contractor administers a defined benefit pension plan and there is no termination advance agreement between the government and the contractor (see 7-606.3):

"The contractor maintains a defined benefit pension plan for its employees. FAR 31.205-6(j)(4) provides that when excess or surplus assets revert to the contractor as a result of the termination of a defined benefit pension plan, or such assets are constructively received by the contractor for any reason, a refund or credit shall be given to the government for its equitable share. The government's equitable share of any reversionary credit applicable to the termination of a defined benefit pension plan should be based upon the government's participation in pension costs of all contracts requiring certified cost or pricing data. In our [enter audit report number or memorandum to ACO] we recommended that the government and the contractor enter into an advance agreement in accordance with FAR 31.109 to avoid possible disallowance or future disputes arising from the termination of a defined benefit pension plan. As of the date of this report no advance agreement has been reached."

e. On proposals expected to result in contracts covered by DFARS clause 252.234-7001, Cost/Schedule Control Systems, or DFARS clause 252.242-7005, Cost/Schedule Status Report, the auditor should provide comments on whether the contractor's C/SC system is meeting the C/SC systems criteria on other contracts and include the impact of deficiencies being reported in C/SC systems surveillance reports (9-316b).

f. If the contracting officer requests specific information on the status of the contractor's systems such as purchasing system, compensation system, or automated data processing system, this information may be provided in this Appendix.

10-307.6 Appendix — Comments on Profit

Prepare comments on profit in accordance with 9-900. Normally comments are limited to items which might affect quantifying weighted guideline factors. Do not show percentage computations under the weighted guideline method or application of an incentive profit formula either here or in an exhibit or schedule of the report. Examples of comments on the profit factor, "Contractor's Performance Risk — Cost Considerations," are shown below (see 9-900 for other factors to be covered):

"The contractor does not consistently base its proposed unit prices on the latest production labor hours and material prices incurred for the same or similar units. Details on this estimating deficiency are presented in our Report on Review of XYZ Company's Estimating System (09900-91A24000001, dated 30 November 1990). Specific reference to the deficiency and discussion of its impact on this pricing action are included in Exhibit A, Notes 2 and 3, and Appendix 2."

"The contractor has three engineering departments which differ greatly in the proportion of journeyman engineers and notable or scarce engineering talent employed in each department. This proposal is based on engineering performance by the department having the least amount of notable engineering specialties and the lowest level of engineering experience."

10-307.7 Appendix — Subcontracts Requiring Contractor Cost Analyses

Use this appendix to identify subcontracts for which the contractor has not completed cost analyses required by FAR 15.806-1 (see 9-104.1). Provide this information even if assist audits have been performed or the auditor has reached a definitive conclusion by other means (e.g., applying a decrement factor or rate check). In the appendix, include the names of the subcontractors, proposed

amounts, and the following explanatory note:

"FAR 15.806-1 requires prime contractors and higher-tier subcontractors to conduct cost analysis of each subcontract proposal for which cost or pricing data are required. In coordinating the need for assist audits, we informed [insert name(s) of ACO/PCO or representatives] on [insert date] of the contractor's planned schedule for completing the cost analyses. As of [insert date field work completed], XYZ Corporation had not completed the required cost analyses for the subcontractors listed above. The contractor's scheduled date for completing the cost analyses is [insert revised date(s)]. These analyses should be submitted to the contracting officer prior to completion of prime contract negotiations."

10-307.8 Appendix — Individuals Having Access to Proprietary or Source Selection Information

a. Pursuant to the procurement/integrity/provisions found at 41 U.S.C. 423, contracting officers are required to maintain a record of all persons who have been authorized to have access to proprietary or source selection information during the award or modification of a contract. To assist the contracting officer in meeting this requirement, a list of all auditors (including supervisory auditors and FAO managers) who worked on the price proposal will be provided in this Appendix to the audit report. The names of administrative personnel who processed the audit report will not be shown in this Appendix. Instead, the Appendix will note that a class of persons, namely administrative personnel, also had access to the data. The names of Regional Audit Manager or other audit personnel should also be listed in the Appendix if they accessed proprietary or source selection information during the proposal evaluation.

b. This Appendix should only be contained in audits of proposals for the award of contracts or modifications (as defined in FAR 3.104-4(e)) for the addition of new work to a contract, or the

extension of a contract, which requires a justification and approval as addressed in FAR 6.3. It is not required for an option where all the terms of the option, including option prices, are set forth in the contract and all requirements for option exercise have been satisfied. It is also not required for change orders, administrative changes, or any other contract changes that are within the scope of the contract.

10-307.9 Appendix — Incorporation of Government Technical Reports

a. See 9-103, 9-307, and Appendix D-300 for specific procedures on obtaining technical assistance/reports and for guidance on incorporating technical information/opinions into the audit conclusions. FAR 15.805-5(e)(6) requires that the audit report include the originals of all technical analyses received by the auditor and a quantification of the dollar effect of the technical analysis findings. The final appendix of the report is reserved for presentation of the technical reports. Copies of technical reports will be included with all audit report copies distributed.

b. The report prepared by the government engineering specialist shall be used unless the findings are, in the auditor's opinion, unrealistic. The auditor shall attempt to reconcile any disagreements concerning the findings with the engineering specialist and/or the responsible supervisory personnel. Assistance to resolve the differences shall be solicited from the contracting officer, if necessary. If the auditor is unable to resolve the differences, the technical report shall not influence formation of the audit opinion or the development of the questioned cost. However, the audit report shall include the technical report as the final appendix and explain why it was not used.

c. If the required technical information/report has not been received, qualify the audit scope statement and provide comments under "Circumstances Affecting the Audit," "Summary of Audit Results," and the appendix "Incorporation of Government Technical Reports." Use the guidance in D-300 and 10-304.2d(1).

d. The procurement regulations of some non-DoD organizations (e.g., NASA) do not include a provision comparable to FAR 15.805-5(e)(6). Consequently, these organizations may not provide for routine submission of reports of technical review. Therefore, a non-DoD office requesting an audit should be promptly advised of the need for a technical report so that arrangements may be made for a technical review without delay.

10-308 Presentation of Information and Audit Results

a. Your explanations, opinions, and recommendations should be clear, concise, and objective. Essential information, however, should not be omitted for the sake of brevity. Explanations should always contain enough information to permit the contracting officer to fully understand the basis for your conclusions and recommendations.

b. The objective of the pricing proposal audit report is to provide recommendations and information useful to the negotiation of fair and reasonable price and contract terms. It is not sufficient merely to report exceptions without supporting explanations. Information regarding the contractor's rationale, the audit tests, and the measurement of impact is essential for the contracting officer to understand and sustain the recommendations. Therefore, reporting information pertinent only to those items being questioned may not be sufficient. The auditor must use judgment concerning the extent of information that will be useful to the contracting officer. For example, if the auditor finds the use of decrement factors or the use of subjective estimates when similar actual costs are available, the circumstances should be described and/or the reader referred to the contractor's written explanation, if any. If the contractor has applied a significant decrement factor without fully disclosing in its proposal the method used to develop the factor and specifying the base to which it applies, it is essential that the audit report provide this information. Likewise, if the auditor has developed a decrement while evaluating cost estimates, the audit re-

port should discuss the method used to develop it and identify the base to which it applies. An explanation of a subcontract decrement should specifically state whether the factor is applicable to competitive and/or noncompetitive quotations (see 9-404.6). For example, a note about subcontracts in a price proposal audit report might include the following:

"The contractor applied a 3.5 percent decrement factor to proposed subcontract costs. This factor represents the difference between subcontract quotations and actual negotiated amounts for the three-year period ending 30 June 1990. This decrement is applicable to both competitive and noncompetitive quotations."

Without this explanation, the cost impact of revisions to a proposal may be erroneously calculated because of a misunderstanding of the method by which the original amount was developed. The auditor should anticipate such conditions when preparing the report and ensure that explanatory notes minimize possible misinterpretations.

c. In preparing the report, the auditor should refer the reader's attention in appropriate circumstances to pertinent data included in the contractor's submission, rather than unnecessarily repeating it in the report.

d. Explanations such as "not necessary or incident to contract performance" or "solely related to commercial business" usually require further amplification to adequately support a questioned cost. For example, in a contract repricing audit, instead of "not necessary or incident to contract performance," an explanation might read:

"The contractor acquired titanium rods and tubes from the Astro Metals Company on Purchase Order 12-18653, dated 5 January 1988, and charged them directly to the contract. The bill of material does not show a requirement for this material under the contract, nor could the contractor substantiate that the items were physically used on the contract. Government technical per-

sonnel have advised that titanium rods and tubes were neither required nor used in performance of the contract; therefore, we have questioned the total amount proposed for this charge."

e. CAM should not be cited as the reason for treating costs as questioned, unsupported, or unresolved (see Introduction to Manual, 0-002). When government regulations are specifically mentioned or incorporated by reference in the contract or in the terms governing submission and negotiation of the price proposal, and costs are questioned based on such regulations, the specific reference should be cited in the explanatory note describing the circumstances underlying the questioned cost. The citation should be accompanied by an appropriate explanation of the audit conclusion in terms of the reasonableness, allocability, or other factors affecting the acceptability of the cost.

f. When quantitative methods are used as a basis for the audit conclusions, this should be mentioned in the explanation of the individual cost elements examined. The report should adequately explain the computations and rationale supporting your conclusion; however, it need not include statistical measurements which are not relevant to price negotiations. For example, comments on confidence levels or confidence limits should not be included in audit reports unless the contractor has cited confidence intervals in its proposal as support for predicted costs.

(1) When costs are questioned based on a statistical sample, the report need not present the sampling plan, recommendations on individual items examined, or calculations of questioned costs if the contractor has agreed with the audit conclusions. For example, the explanatory note might state:

"We applied scientific sampling techniques to the raw material cost estimate. We tested selected items by comparison with the quantitative requirements shown in the bill of material which the government technical representative recommended for acceptance. We compared the dollar

values for the selected items with the latest vendor quotations. We consider the contractor's solicitation of prospective sources adequate. In a number of instances, however, the material quantities or prices included in the contractor's estimate exceeded the requirements or lowest quotations, without adequate justification. Applying statistical projection techniques to this cost category on the basis of the exceptions noted, we have questioned \$80,000 in estimated raw material costs. The contractor's representative concurred with this adjustment."

(2) When costs are questioned based on a regression analysis or an improvement curve, the auditor's explanation should identify data used in the analysis and explain any differences between these data and amounts appearing in the contractor's cost representations. Graphic presentations of regression lines and improvement curves, whenever practical, should be included in the audit report. The report may also include computer printouts when there are indications that negotiators will find this information valuable during negotiations.

g. Exhibits and schedules included in the report will state the results of audit using columns labeled "Questioned Costs," "Unsupported Costs," and "Unresolved Costs." These columns should be used only if costs are to be reported in them; otherwise, they should be omitted from the format. The captions are explained in 10-308.1, 10-308.2, and 10-308.3, respectively. One additional column, labeled "Difference," is shown to the right of the final column needed to report the results of audit. The function of this column is explained in 10-308.4.

h. Suggested formats for audit report exhibits are illustrated in Figures 10-3-2 and 10-3-3. These formats may also be used for schedules if appropriate. Modifications should be made only when the circumstances clearly require a deviation. Supporting schedules are preferred over lengthy and complex footnotes to the principal exhibits.

10-308.1 Questioned Costs

a. Those amounts on which audit action has been completed and which are not considered acceptable as a contract cost will be shown as questioned costs. This category includes amounts for:

(1) Those items specifically identified as unallowable under the contract terms, statute, public policy, applicable government regulations, or legal advice.

(2) Those items which, although not specifically unallowable under (1) above, are determined to be unreasonable in amount, contrary to generally accepted government accounting principles, or not properly allocable to the contract considering the relative benefit received or other equitable relationship.

(3) The impact on proposed costs of cost avoidance recommendations based on implementation of the cost reduction programs listed in 9-317.

(4) Those items questioned for other reasons, usually based on government engineering or technical advice.

b. If part of a cost element or account is not acceptable, only that part should be questioned.

c. If a cost element in the contractor's proposal has been significantly understated, the understated amount should be shown in the Questioned Costs column in parentheses to denote an increase for that element. If a portion of the cost element is also questioned, the net amount should be reflected. An adequate explanation should be given in all cases.

d. Explanations regarding questioned costs should be sufficiently informative to allow the reader to fully understand the basis for the audit conclusions. The explanations should normally be shown as footnotes to exhibits and supporting schedules.

10-308.2 Unsupported Costs

a. Those costs for which the contractor does not furnish sufficient documentation to enable a definitive conclusion to be reached should be classified as unsupported. Classification of costs as unsupported is of no value to the contracting officer. Therefore, the auditor should vigorously pursue action to obtain the needed cost or pricing data (see 9-205a).

These actions must be taken promptly to avoid delays in completing the audit. Also classify as unsupported any proposed subcontract where the ACO/PCO decided to wait for the contractor completion of the required cost analysis rather than request an assist audit (see 9-104.2d).

b. Prompt requests for assistance to both the ACO and PCO are critical and should be confirmed in writing. The auditor should clearly identify the data needed and state how its absence would affect the overall audit opinion.

c. When all attempts fail (including ACO and PCO assistance) to obtain the necessary supporting data, the auditor should include comments in the audit report on the action taken and classify the costs as unsupported. For example, a "circumstances affecting the audit" paragraph might read:

"A significant proportion of the contractor's proposed costs is unsupported. We sought the assistance of both the ACO and PCO and advised them on 10 October 1990 of the items and the types of documentation necessary to support the costs (see Exhibit A, Note 8). If the contractor furnishes adequate supporting documentation prior to negotiations, we will provide a supplemental report to dispose of the unsupported costs if such a report would serve a useful purpose."

d. The report should state that the contractor was advised of the unsupported costs (see 4-304.2d). The explanatory notes for items classified as unsupported costs will state the types of documentation considered necessary to adequately support the items and describe the auditor's efforts to obtain such documentation.

e. Overhead and G&A expense applicable to unsupported costs should not be quantified in the Unsupported Costs column. The rates applicable to unsupported costs should be stated in the explanatory notes so that the rates can be applied to any portion of the unsupported base costs not accepted by the contracting officer to develop the corresponding

amount of additional questioned overhead and G&A costs. When costs are classified as unsupported in subcontract audit reports, the subcontract auditor will identify the subcontractor loading factors, including profit, in the explanatory notes or by separate schedule so that they may be easily applied to the corresponding base costs in the prime contract report.

10-308.3 Unresolved Costs

a. Failure to receive requested DCAA assist audit reports will necessitate classifying the applicable proposed amounts as unresolved (see 9-104). The unresolved classification is also used when there are significant incomplete subcontract pricing actions applicable to repricing proposals for incentive and fixed price redeterminable contracts. Costs should not be classified as unresolved in any circumstances other than those cited in this paragraph.

b. The guidance in 10-308.1d on the presentation of explanatory comments on questioned costs also applies to unresolved costs. Overhead and G&A expense applicable to unresolved costs will not be quantified in the Unresolved Costs column; however, applicable rates will be provided as described in 10-308.2e.

c. The additional information or action required before a definitive conclusion can be reached on unresolved items will be stated in the footnotes or in the narrative portion of the report, together with a statement of the auditor's intentions with respect to issuance of a supplemental audit report. This statement should be based on the criteria in e below and on the latest information available prior to release of the initial audit report.

d. A supplemental report should be issued when costs in this category are resolved provided the contract negotiation has not been concluded and the report will serve a useful purpose. For example, subcontract costs may have been classified as unresolved in the audit report on the repricing of an incentive-type prime contract, pending negotiation by the contractor and subcontractor of a firm final subcontract price. In these cases, the prime contract price will usually not be finalized until a final price for

the subcontract has been established. If this procedure is being followed, a supplemental report should be issued after a firm subcontract price has been established and the auditor responsible for the prime contractor has reviewed the data supporting the settlement. Any questions at that time regarding the current status of prime contract negotiations should be discussed with the contracting officer.

e. The supplemental report need not restate the information or recommendations included in the prior report. It should be limited to unresolved items, unless their resolution affects other cost elements or a complete restatement would be more useful to the contracting officer.

10-308.4 Difference

a. A "Difference" column will be included in the standard format for exhibits and appropriate schedules (see 10-308g) prepared for use in reports on price proposal audits only (see Figures 10-3-2 and 10-3-3). The "Questioned," "Unsupported," and "Unresolved" columns are included in the group "Results of Audit" and are positioned, as needed, in that order to the right of the "Proposed" column. The "Difference" column is placed to the right of the last column in the "Results of Audit" group and is not a part of that group.

b. The "Difference" column is intended for the use of the contracting officer in preparing the government's negotiation objective. It should show for each cost element the arithmetic difference between the amount proposed and the sum of the related questioned, unsupported, and unresolved amounts. The amounts in this column should not be regarded or referred to as "audit-approved" or "recommended" amounts.

10-308.5 Qualifications for Lack of Technical Reports or Contracting Officer Approvals

a. Conclusions on the acceptability of certain items shown in the contractor's cost representation or proposal should be qualified under the following conditions:

(1) When the requested technical report on the quantitative or qualitative aspects of the contractor's proposal has

not been received, and the acceptability of these matters cannot be determined by other available audit procedures (see 9-103.3, 10-304.2d, and D-200).

(2) When acceptance of a cost otherwise allowable is contingent upon the contracting officer's specific consent or approval (e.g., premium pay for overtime requiring approval) which has not been granted but which you believe will be forthcoming.

b. Qualifications will not be quantified in the questioned, unsupported, or unresolved costs columns in the exhibits and schedules. They should be fully explained, however, by cost element and amount in footnotes on the applicable exhibits and schedules keyed to the items qualified. The footnotes should also contain enough information, either explicitly or by reference, so that in conjunction with the supporting data in the contractor's proposal, the report recipient can understand what adjustments may be necessary once the data which necessitated the qualification are received. For example, if direct labor cost is qualified because a technical report was not received, enough information should be included on accepted hourly rates for each direct labor classification as well as on accepted indirect cost rates (manufac-

turing, general and administrative, etc.) which are applicable to the qualified direct labor cost to allow calculation of any necessary adjustments in audit results. (If proposed direct labor or indirect cost rates are questioned, the dollar effect should, of course, be shown in the questioned costs column rather than expressed as a qualification.)

c. When the principal exhibit is supported by supplementary exhibits and schedules for the major cost elements (direct material, direct labor, etc.) the qualifications should be detailed on these supporting tabulations. In such a case, the principal exhibit will contain only one general qualification making appropriate references to the supporting explanations. Detailed explanations of qualifications will appear in the principal exhibit only if there is no supporting exhibit or schedule for the cost element to which the qualification pertains.

d. The disposition of audit results paragraph (see 10-304.4) should mention the intention to issue a supplemental report if such action is contemplated. The supplemental report should normally show the monetary effect on both direct and indirect costs of quantitative changes recommended by technical personnel.

January 1995

Audit Report No. _____

XYZ Corporation
Portland, Oregon

Government Solicitation No. _____
Supplies and/or services to be furnished _____

Proposed for

<input type="checkbox"/> Initial pricing	<input type="checkbox"/> Contract Change or Modification
<input type="checkbox"/> Price redetermination	<input type="checkbox"/> Definitization of Letter Contract No. _____
	<input type="checkbox"/> Other purposes (Describe) _____

Date of Request _____
Procuring Activity _____

DCAA Contract Audit Manual

January 1995

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Figure 10-3-2

Figure 10-3-2
EVALUATION OF FORWARD PRICE PROPOSAL

Audit Report No. _____

EXHIBIT A
Page 1 of XX

XYZ Corporation
Philadelphia, Pennsylvania
STATEMENT OF CONTRACTOR'S PROPOSAL
AND RESULTS OF AUDIT
DEFINITIZATION OF LETTER CONTRACT NA2-201

Elements of Proposal	Contractor's Proposal	Results of Audit (Note 1)			Difference (Note 2)	Reference
		Questioned Costs	Unsupported Costs	Unresolved Costs		
Material:						
Subcontracts	\$1,000,000	\$ 11,500	\$100,000	\$360,000	\$ 528,500	Note 3
Purchased Parts	500,000	65,000	—	—	435,000	Note 4
Raw Material	1,000,000	—	—	—	1,000,000	Note 5
Direct Labor:						
Factory (625,000 hrs)	2,100,000	210,000	—	—	1,890,000	Note 6
Engineering (470,000 hrs)	3,000,000	120,000	—	—	2,880,000	Note 7
Overhead:						
Factory	4,200,000	870,000	—	—	3,330,000	Note 8
Engineering	3,000,000	408,000	—	—	2,592,000	Note 9
Total Manufacturing Costs	14,800,000	1,684,500	100,000	360,000	12,655,500	
G&A Expenses	1,036,000	380,225	—	—	655,775	Note 10
Total Cost	15,836,000	<u>\$2,064,725</u>	<u>\$100,000</u>	<u>\$360,000</u>	<u>\$13,311,275</u>	
Profit	1,425,000					See Appendix 5*
Total Proposed Price	<u>\$17,261,000</u>					

* See 10-307 for illustration of comments to be included in the appendix.
Note: For simplicity of illustration, it is assumed that the cost of money is not applicable.

Explanatory Notes

1. The results of audit are qualified, as described in Notes 6 and 10.
2. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and the sum of the related questioned, unsupported, and unresolved costs. They are not to be considered audit-approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters. As stated in Note 3 below, the applicable G & A Expense rate has not been applied to the base costs in the Unsupported and Unresolved columns. The accepted 5 percent G & A Expense rate must be applied to any such base costs not accepted by the contracting officer in order to determine the amount of any related additional unacceptable G & A Expense.

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Figure 10-3-2

January 1995

3. Subcontracts

a. Questioned Costs

(1) GHI, Inc. fixed-price proposal included in contractor's proposed subcontracts.

\$150,000

Subcontract price negotiated with GHI, Inc., using XYZ Corporation's internal audit report 19-7-1142 was \$145,650. Based on analysis of the negotiation record, the audit report, and the audit procedures used, we believe that the audit results were adequately considered in the negotiation.

145,650

4,350

(2) Fixed-price subcontract proposal for \$120,000 from IJK Company was included in the contractor's proposed subcontract costs. The subcontract audit report furnished the contractor questioned direct labor plus factory overhead and G&A expenses of \$6,500 on the basis that IJK Company had recognized no learning in its labor estimate. We have questioned the amount set out in the subcontract audit report plus profit applicable to those questioned costs at the subcontractor's proposed rate of 10 percent ($\$6,500 + 650 = \$7,150$).

7,150

Total Questioned Costs

\$ 11,500

b. Unsupported Costs

(1) Unsupported costs of \$100,000 represent an estimate by the contractor's engineering and purchasing departments of the cost to acquire ten temperature and humidity controller equipment consoles of special design. We found that the engineering drawings were only partially complete and that price proposals had not been requested from prospective subcontractors. The contractor has had no cost experience in manufacturing or subcontracting these or similar equipment consoles. The contractor based this estimate on telephone discussion of the specifications with a potential supplier.

(2) In the absence of a definitive subcontractor proposal or contractor experience in acquiring consoles of this nature, we were unable to reach a conclusion on the proposed costs. We advised the contracting officer on 1 July 19 _____ of the contractor's failure to make available the necessary supporting data. In the event the contractor later furnishes such data, we will provide supplemental audit advice as promptly as possible after receipt.

(3) To simplify this report, G&A expense allocable to the unsupported costs has not been quantified. Accordingly, our adjusted G&A rate of 5 percent should be applied to any portion of the proposed \$100,000 not accepted by the contracting officer (see Note 10).

Total Unsupported Costs

\$ 100,000

c. Unresolved Costs

(1) The requested field pricing report on the ABC Manufacturing Company proposal for \$360,000 has not been received, nor has XYZ's internal audit staff completed its review of ABC's proposal. Upon receipt of the subcontract field pricing report, we will issue a supplemental audit report, recommending disposition of these unresolved costs, provided negotiations have not been completed.

(2) G&A expense allocable to these unresolved costs has not been quantified. Our adjusted G&A rate of 5 percent should be applied to any portion of the unresolved cost not accepted by the contracting officer (see Note 10).

Total Unresolved Costs

\$ 360,000

January 1995

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Figure 10-3-2

d. The remaining \$528,500 of subcontract costs in the contractor's proposal represents three subcontracts which, in our opinion, have been awarded on the basis of adequate price competition.

e. The government technical report states that the contractor-designed components being subcontracted are required by the present design configuration of the prototype and are consistent with the approved make-or-buy plan.

4. Purchased Parts

a. Questioned costs are based on the government technical report and consist of the following:

(1) Value of transformers proposed in error. These items are to be supplied as government-furnished property as stipulated in the contracting officer's request for proposal. The contractor's representative concurred.

\$ 59,400

(2) Cost of ten Model K servo motors which are in excess of the bill of material requirement ($200 - 190 = 10 \times \$560$).

5,600

Total Questioned Costs

\$ 65,000

b. Except for the above, our tests indicated that purchased parts were proposed in quantities consistent with the bill of material and at prices based on lowest vendor quotations, established catalog prices for most favored customer, and current purchase order experience.

5. Raw Material

The government technical report took no exception to the kind and quantity of the raw material proposed. In addition, we found that the materials are regularly stocked in the contractor's inventory and for the purpose of this proposal were quoted at current stock card prices adjusted downward for anticipated price reductions due to increased quantity requirements. We find no basis on which to question the proposed costs.

6. Direct Labor—Factory

a. Details of the contractor's proposal and the costs questioned with respect to direct factory labor are shown below:

	Contractor's Proposal	Questioned Costs
Straight time wages:		
625,000 hours @ \$3.20 per hour (including 62,500 overtime hours)	\$2,000,000	\$200,000
Premium portion of wages:		
62,500 hours @ \$1.60 per hour	<u>100,000</u>	<u>10,000</u>
Totals	<u>\$2,100,000</u>	<u>\$210,000</u>

b. We believe that the contractor's proposed straight-time hourly rate of \$3.20 and overtime premium rate of \$1.60 are overstated. As of the date of our review, the average straight-time rate was only \$2.88, and the average overtime premium was only \$1.44. The differences of \$.32 and \$.16 per hour, respectively, represent a provision for an average general wage increase anticipated by the contractor in its proposal, but which was not incorporated in the contractor's recent wage agreement with its employees. Accordingly, we have questioned 625,000 hours of straight-time wages at \$.32 per hour (\$200,000) and 62,500 premium hours at \$.16 per hour (\$10,000).

c. In addition, the acceptability of direct factory labor cost is qualified to the extent of the overtime premium (62,500 hours at \$1.44 per hour = \$90,000), since the contracting officer has not yet determined the necessity for or the reasonableness of the contractor's proposed use of overtime.

d. The contractor has proposed factory direct labor to produce this prototype model on the basis of factory operations standards. These standards represent effort required at the one-hundredth production unit. The contractor has converted standard hours for the prototype to estimated actual hours on the basis of an 80 percent improvement curve extended back to the number one unit. The contractor has experienced an approximate 80 percent improvement in factory labor efficiency on other similar products, and we found no basis on which to question the proposed direct labor hours in this instance. The government technical report also took no exception to the proposed hours.

7. Direct Labor—Engineering

a. Our audit indicates that only 450,000 engineering hours would be needed for all engineering labor operations, as compared with the contractor's proposal of 470,000 hours. The difference is attributed to the contractor's use of a 156.7-hour staff-month factor as opposed to the 150-hour factor used in our evaluation. (See Schedule A-2**) The government technical report concurred in the proposed staff-months. Accordingly, questioned costs consist of the difference of 20,000 hours at the contractor's rate of \$6.00 per hour, or \$120,000.

b. The contractor's engineering hourly labor rate is based on current experience of Department 6-3 projected to include merit pay increases for the period of contract performance. The rate of \$6.00 per hour represents the midpoint of effort. We consider the rate reasonable.

*8. Overhead—Factory

a. The contractor's proposal was based on an overhead rate of 210 percent applied to straight-time factory direct labor cost. This rate was the contractor's actual rate for the prior fiscal year ended 31 March 1987. During the audit the contractor announced that production of a commercial version of a military item (X-4B) the company is now producing would start within the next several months. The contractor agreed that the proposed overhead rates did not reflect this decision and that the commercial work would substantially increase production volume over that of the prior year. The contractor stated that revised overhead rates would be submitted at the negotiation.

b. Pending receipt of the contractor's revised submission and in accordance with your request, we have projected revised rates for the period of contract performance which reflect the decision to produce the commercial version of the X-4B. The detailed computation of projected rates is shown in Schedule A-1**. It is based on consideration and analysis of (1) production schedules and cost planning information for the new item, (2) fixed and variable expense ratios for the past several years, and (3) available budgetary data for sales and production. As shown in Schedule A-2, we have projected a revised overhead rate of 185 percent as compared with the contractor's proposed rate of 210 percent. This represents an overhead rate reduction of 25 percentage points (210-185). The questioned amount consists of the following:

25% on total factory direct labor cost exclusive of overtime premium (\$2,000,000)	\$500,000
185% on questioned factory labor cost exclusive of overtime premium (\$200,000) (See Note 6)	370,000
Total Questioned Costs	<u>\$870,000</u>

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Figure 10-3-2

***9. Overhead—Engineering**

The contractor's proposal was based on a 100 percent overhead rate, the actual rate for the fiscal year ended 31 March 1987. We adjusted this to 90 percent to reflect the projected increase in volume of business (see Note 8). The questioned amount consists of:

10% of total engineering labor cost (\$3,000,000)	\$300,000	
90% of questioned engineering labor cost (\$120,000)	<u>108,000</u>	(See Note 7a)
Total Questioned Costs	<u>\$408,000</u>	

***10. G&A Expenses**

a. The contractor's proposal was based on a 7 percent (prior period actual) G&A expense rate. We computed a rate of 5 percent which reflects the projected increase in volume of business (see Note 8). The questioned amount consists of:

2% of total manufacturing costs (\$14,800,000)	\$296,000	
5% of questioned base costs (\$1,684,500)	<u>84,225</u>	
Total Questioned Costs	<u>\$380,225</u>	

b. In addition, the acceptability of general and administrative expense is qualified to the extent this expense is applicable to the direct factory labor cost qualified (see Note 6).

*In order not to overly complicate this exhibit, Notes 8, 9, and 10 assume no items were questioned in the overhead and general and administrative expense pools, and therefore, the adjustments to the respective rates were based entirely on a projected increase in the volume of business.

**Schedules A-1 and A-2 not included as not considered necessary for illustrative purposes.

Figure 10-3-3
REPORT TO ESTABLISH FINAL PRICE OF
FIXED-PRICE INCENTIVE CONTRACT

Audit Report No. _____

EXHIBIT A
Page 1 of XX

XYZ Corporation
Philadelphia, Pennsylvania
STATEMENT OF CONTRACTOR'S PROPOSAL
AND RESULTS OF AUDIT
ESTABLISHMENT OF FINAL PRICE OF
FIXED-PRICE INCENTIVE CONTRACT NO. _____

Cost Elements	Contractor's Statement	Results of Audit		Difference (Note 1)	Reference
		Questioned Costs	Unresolved Costs		
Material:					
Raw and stores material	\$1,200,000	\$43,300	—	\$ 1,156,700	Note 2
Purchased parts	586,893	10,000	—	576,893	Note 3
Off-the-shelf items	100,000	—	—	100,000	
Subcontracted items	800,000	—	\$207,000	593,000	Note 4
Interdivisional transfers	125,000	9,000	—	116,000	Note 5
Direct engineering labor	3,500,000	150,000	—	3,350,000	Sched A-1*
Engineering burden	3,500,000	150,000	—	3,350,000	Note 6
Direct manufacturing labor	2,400,000	96,000	—	2,304,000	Sched A-2*
Manufacturing burden	4,800,000	744,960	—	4,055,040	Sched A-3*
Spoilage and rework	84,357	17,869	2,070	64,418	Note 7
Packaging and crating	41,000	—	—	41,000	
Special tooling	65,000	—	—	65,000	
Total Manufacturing Cost	17,202,250	1,221,129	209,070	15,772,051	
G&A Expense	1,376,180	97,690	—	1,278,490	Note 8
Total Cost	18,578,430	\$1,318,819	\$209,070	\$17,050,541	
Profit	1,998,000				
Total Price	\$20,576,430				

*Not included as not considered necessary for illustrative purposes.

Note: For simplicity of illustration it is assumed that the cost of money is not applicable.

Explanatory Notes

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and the sum of the related questioned and unresolved costs. They are not to be considered audit-approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters. As stated in Note 8 below, the applicable G & A Expense rate has not been applied to the base costs in the Unresolved column. The accepted 8 percent G & A Expense rate must be applied to any such base costs not accepted by

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Figure 10-3-3

the contracting officer in order to determine the amount of any related additional unacceptable G & A Expense.

2. Raw and Stores Material

Represents overstatement of costs for part no. 345, steel plates (8,660 plates at \$5.00 each) charged to the contract. These charges were based upon average unit prices and the standard usage per item as shown in the contractor's bill of material. Selective review of the bill of material charges disclosed that the contractor had erroneously applied the unit price of part no. 354 (\$12) rather than the unit price of part no. 345 (\$7). The contractor's representative concurred in this adjustment.

3. Purchased Parts

Represents cost of five transformers purchased from the government to replace transformers originally supplied as government-furnished property which were damaged by contractor and could not be used. This cost is not considered allowable, as the government technical inspector determined the damage was due to gross negligence. The contractor's representative does not concur.

4. Subcontracted Items

Unresolved item represents costs submitted by JKL Corporation, a subcontractor under a fixed-price incentive subcontract, on which an assist audit was requested but has not yet been completed. Provided that the prime contract negotiation has not been concluded, we will issue a supplemental report upon receipt of the assist audit report, showing the ultimate disposition of the unresolved cost. We anticipate that this report will be issued on approximately _____ (date).

5. Interdivisional Transfers

Represents excess price for switches obtained from PQR Electrical Parts Division of contractor, in accordance with FAR 31.205-26, as follows (contractor concurs):

Unit price billed by PQR Electrical Parts Div.—6,000 @\$9.00	\$54,000
Unit price charged by PQR Electrical Parts Div. to its most favored customer for like quantity—6,000 @ \$7.50	<u>45,000</u>
Amount Questioned	<u>\$9,000</u>

6. Engineering Burden

Represents engineering burden, at a rate of 100 percent applicable to questioned direct engineering labor costs. The contract was started and completed within the contractor's fiscal year ended 30 November 1987. We consider the 100 percent rate proposed by the contractor for this period to be acceptable.

7. Spoilage and Rework

The contractor proposed a 3 percent spoilage and rework factor since this item is not an element of the bill of materials. Any additional materials used and the costs of reworking rejects are charged to the spoilage and rework account. Our analysis of the account, other historical data and information from the government technical inspector indicate that the 3 percent factor is not acceptable for subcontracted items. For subcontracted items, past experience shows that a 1 percent factor is more realistic because these high dollar value major components require only assembly by the contractor. Accordingly, questioned costs and unresolved items were computed as follows (the contractor does not concur in the 1 percent rate).

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Questioned costs:

Spoilage and rework factor of 3 percent applied to questioned direct material cost of \$62,300 (see Notes 2, 3, and 5)	\$1,869
Excessive spoilage and rework factor (2%) applied to subcontracted items of \$800,000	<u>16,000</u>

Amount Questioned

\$17,869

Unresolved items:

Accepted spoilage and rework factor for subcontracted items (1%) applied to unresolved subcontracted items of \$207,000	<u><u>\$2,070</u></u>
---	-----------------------

8. General & Administrative Expense

Questioned amount represents a G&A expense rate of 8 percent applied to questioned costs. The 8 percent rate proposed by the contractor for the fiscal year ended 30 November 1987 encompasses all performance under this contract. We consider the proposed G&A expense rate to be acceptable. To simplify this report, the G&A expense allocable to the unresolved subcontract and spoilage costs of \$209,070 (Notes 4 and 7) has not been quantified. Accordingly, the acceptable G&A expense rate of 8 percent should be applied to any portion of the unresolved costs not accepted by the contracting officer to determine the corresponding additional G&A expense questioned.

10-400 Section 4 - Audit Reports on Operations, Internal Control and Other Functional Audits**10-401 Introduction**

a. This section provides guidance for preparing and distributing reports on

- (1) reviews of contractors' operations for economy and efficiency, including those required under DFARS 242.70 ("Monitoring Contractors' Costs"),
- (2) internal control audits of contractor accounting and management systems (Chapter 5), and other related functional audits (Chapter 6), and
- (3) the various types of surveys identified in Chapters 5, 9, 11 and 14. Supplemental guidance for performing estimating system surveys is presented in 5-1200 and supplemental report guidance for compensation audits is presented in 5-811.3.

b. These audits and surveys may be initiated (1) under a cost monitoring program, (2) upon request of the contracting officer, or (3) as part of the field office's responsibility for reviewing contractor systems and day-to-day operations.

10-402 Nature of Reports

These audit reports are designed to provide an independent assessment of performance (i.e., operations audits and efficiency reviews) or compliance with internal control policies and procedures, and applicable laws and regulations. The report provides an audit opinion on whether the contractor is fulfilling its responsibilities in a specific area and gives the contractor and contract administration officials information and recommendations to facilitate corrective actions and improvements.

10-403 Format and Content of Reports

a. Consistent with the new reporting format (MRD 94-PFD-163(R), dated 26 September 1994) and guidance in 10-200,

reports will typically include the following sections:

- (1) Cover Sheet
- (2) Subject of Audit
- (3) Executive Summary
- (4) Scope of Audit
- (5) Results of Audit
- (6) Contractor's Organization and Systems
- (7) DCAA Personnel and Report Authorization
- (8) Audit Report Distribution and Restrictions
- (9) Attachments

b. When reports are being prepared jointly by DCAA and contract administration personnel under a cost monitoring program, the auditor will actively participate in preparing the report. The auditor should ensure that the report meets DCAA standards. If agreement on report content cannot be reached at the field level, the matter should be elevated to the regional office and the counterpart contract administration level. The report should be distributed to the contractor, through the administrative contracting officer.

c. The DCAA Bulletin Board includes examples of report formats under the name NUFORMAT.ZIP.

10-404 Cover Sheet

Follow the general guidance in MRD 94-PFD-163(R), dated 26 September 1994, the examples on the DCAA Bulletin Board under file name NUFORMAT.ZIP and 10-208. All functional reports including reports on joint reviews under DFARS 242.70, regardless of reported conditions, internal control weaknesses, or system deficiencies, will be addressed to the principal cognizant ACO (10-208). For reports involving more than one segment of a company, this will usually be the CACO, unless the segments involved are in the same location and assigned to the same contract administration office.

10-405 Subject of Audit

a. For reports on economy and efficiency (operations audits), this section will clearly identify the area reviewed and the objective. For example:

- (1) For audits not performed under cost monitoring programs, the subject of audit paragraph may read:

"As part of our comprehensive audit of the [insert company name], we have reviewed the contractor's plant maintenance function, which is responsible for the maintenance and repair of equipment and buildings at the Boston facility. We performed the audit to evaluate the effectiveness of the contractor's policies and practices in assuring that maintenance tasks are carried out in a timely, efficient, and economical manner. Our audit was conducted from November 19XX through February 19XX and covered contractor operations for the fiscal year ended 31 December 19XX."

- (2) For audits performed under cost monitoring programs, the same paragraph might begin:

"In accordance with the provisions of DFARS 242.70, we have audited the XYZ Company's (name of department) department (or function) to evaluate . . ."

b. For internal control audits of contractor accounting and management systems (Chapter 5), the subject of audit paragraph may read:

"We have audited [insert contractor's name] [insert system reviewed] system to evaluate the adequacy of and [insert contractor's name] compliance with the system's internal controls for [describe the purpose of the system, i.e., developing accurate, current, and complete cost estimates or accumulating and recording direct labor costs]. (See 5-100).

c. For reviews or surveys discussed in Chapters 5, 9, 11, and 14, the subject of audit section should describe the nature of the survey.

d. This section should also include a responsibility statement. For internal control audits this may read:

"[Insert contractor's name] is responsible for establishing and maintaining an adequate [insert system name] system. Our responsibility is to express an opinion on the adequacy of the [insert system name] system based on our audit."

10-406 Scope of Audit

a. All reports should contain the following scope statement:

"We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the [insert data, records, representations or system name] are free of material misstatement. Our audit includes:

- assessing control risk to use as a basis for planning the nature, timing, extent of testing;
- examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed;
- assessing the accounting principles used and significant estimates made by the contractor; and
- evaluating the overall data and records presentation.

We evaluated the [insert data, records, representations or system name] using the applicable requirements contained in:

- Federal Acquisition Regulations (FAR),
- DoD FAR Supplement (DFARS), and
- Cost Accounting Standards."

b. The scope for an internal control audit would also include:

- obtaining an understanding of the estimating system and related internal controls

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¶10-406b.

- determining if the internal controls are adequate and in operation
- c. For a joint report being prepared under a cost monitoring program, a separate paragraph may be used for a technical scope statement. The technical representative should furnish the actual wording. The audit scope statement for a joint report might begin as follows:

"The financial, accounting, and related aspects of this joint review were performed . . ."

d. The types of contractor records and documents examined should be briefly identified along with a description of unique audit steps or techniques used and the period of performance. Internal control audits should describe the scope of the auditor's work in obtaining an understanding and testing relevant internal control objectives. For example, this paragraph may read:

"Our audit specifically covered the [insert system name] system's internal control procedures associated with the following control objectives: [List the system's control objectives from Chapter 5]"

e. Any factors which restricted or limited the scope of the audit should be clearly described within the scope of audit section under a separate heading entitled "RESTRICTIONS". (See 10-209.2, "Circumstances Affecting the Audit".)

10-407 Executive Summary

This section is intended to give the reader a brief overview of the audit findings. It should briefly describe the audit opinion, recommendations and the significant issues supporting the opinion. This section for an internal control audit of the contractor's estimating system may read:

"In our opinion, the contractor's estimating system is inadequate in some respects. Our audit disclosed two major deficiencies in [insert contractor's name] estimating system that result in overstated and unsupported material and subcontract

costs. As a result, we recommend disapproval of these portions of [insert contractor's name] estimating system.

SIGNIFICANT ISSUES:

1. [Insert contractor's name] does not prepare a consolidated bill of material to support proposed material costs. This deficiency results in overstated material costs since vendor quantity discounts are often not considered when pricing material quantities.
2. [Insert contractor's name] does not analyze subcontractor proposals prior to negotiating the prime contract price. This deficiency results in substantial overstated proposed subcontract costs since [insert contractor's name] achieves reductions in the subcontractor's proposals after the analysis have been performed.
3. [Insert contractor's name] agrees and is taking aggressive action to correct these deficiencies."

10-408 Results of Audit

a. This section should summarize the conditions and recommendations found during the audit. The opening paragraphs will vary according to the nature of the report.

(1) Operation Audits which reveal potential cost avoidance should begin with a statement of the total estimated cost avoidance. For example, the statement might read:

"Our audit disclosed that if the contractor were to use interactive computer graphic techniques rather than manual methods for preparing layouts, schematics, and drawings, an annual cost avoidance of about \$1.1 million could be realized. About \$0.6 million is allocable to government programs."

(a) Follow this statement by briefly describing the conditions that create the opportunity for the estimated cost avoidance, including the amount applicable to each condition and a concise explanation of how adopting the recommendation will result in savings. Acknowledge con-

¶10-408a.

tractor actions which have achieved savings in the area under review. These conditions should be detailed as "Statements of Conditions and Recommendations" (see 10-409).

(b) A paragraph concerning the incorporation of the review's cost avoidance recommendations into price proposals should be included in this section, as in the following example.

"These recommendations pertain to the reasonableness of the contractor's future costs. Therefore, we recommend that the contracting officer instruct the XYZ Company to immediately incorporate the effect of the recommendations into its estimating methods, forward pricing rate schedules, and applicable contract price proposals. These recommendations affect primarily [specify cost area(s), such as general and administrative expense rate, direct engineering design labor cost, and manufacturing overhead rate]. Savings can be achieved as early as [specify quarter and year] if our recommendations are implemented promptly. If XYZ Company does not reflect the cost impact of our recommendations in its proposals, we will, as a minimum, question the costs as being unreasonable in accordance with FAR 31.201-3. We may also recommend that the contracting officer reject future pricing submissions which include the effects of identified inefficient or uneconomical practices."

(c) If significant internal control deficiencies are noted during a functional or operations review, the scope of audit section should identify the deficiencies and state the potential cost impact or the general effect and risk to the government associated with these deficiencies. State that we will initiate a separate internal control audit of the applicable system and issue a separate report. Refer to 10-408a(2) below.

(2) For internal control audits express an overall opinion on the adequacy [i.e., adequate, inadequate in some respects, or inadequate] of those aspects of the accounting and management system and

related internal controls that were reviewed. For example, this paragraph may read:

"In our opinion, the [indicate the system reviewed] system and related internal control policies and procedures of [Insert Contractor's Name] are adequate [or inadequate] [or inadequate in some respects].

If the deficiencies are so significant that the entire system is unreliable, the audit opinion should be that the system is inadequate. If the deficiencies affect only parts of the system, then the audit opinion should state that the system is inadequate in some respects and identify the inadequate portions of the system. Also, if significant deficiencies are reported, the opinion on the system should either be "inadequate in some respects" or "inadequate". If items are found that do not impact the adequacy of the system but would enhance the system if corrected, they should be reported as "Suggestions to Improve the System" (see (b) below). These items should not be reported as deficiencies.

(a) If our audit disclosed significant deficiencies, the results of audit should identify the deficiencies and the affected costs. This paragraph should also provide the estimate of costs affected by deficiency (i.e., direct cost and related indirect expense). For example, if the deficiencies result in unallowable costs being charged to the government, the estimated amount of unallowables would be disclosed. If the unallowable amount is undeterminable, the costs generated by the deficient system (or portion of the system) would be disclosed (e.g., if labor transfer documentation was deficient, the cost related to the labor transfer would be disclosed). The deficiencies and the related cost impacts (see 10-209.3h(2)) should be summarized here and detailed in the "Statement of Conditions and Recommendations" appendixes. For example, this paragraph may read:

"Our audit noted certain significant deficiencies in the design or operation of the internal control structure. In our judgement, these deficiencies could adversely affect the organiza-

tion's ability to record, process, summarize, and report [indicate the nature of costs associated with the system(s) reviewed, i.e., labor incurred costs] in a manner that is consistent with applicable government contract laws and regulations. These conditions are detailed in the "Statement of Conditions and Recommendations" appendixes and summarized below:"

(b) If the auditor identified deficiencies which are not considered to be significant but correction would enhance the system, they should be reported in an appendix to the report entitled "Suggestions to Improve the System" and referred to in the "Results of Audit" section of the report. For example, this paragraph may read:

"During the course of our review, we also noted other matters involving the [indicate system being reviewed] system and related internal controls which, although not considered to be significant deficiencies at this time, we believe should be communicated to the management of [Insert Contractor's Name]. These matters are detailed in the "Suggestions to Improve the System" appendix to this report."

(c) Report the auditor's overall control risk assessment and the impact this assessment will have on the nature and extent of audit effort on other financial related audits. For example, this paragraph may read:

"Overall, we have assessed control risk relating to the contractor's [indicate system reviewed] as [low/moderate/high]. As a result, our audit effort in the following areas will be [increased/decreased]: [List the audit areas affected and the changes in audit effort]".

(d) If significant deficiencies are reported for systems where FAR/DFARS provides for approval/disapproval (i.e., estimating and purchasing) and the deficiencies have not been corrected, recommend disapproval of the identified part or the entire system. For all systems, if

the contractor has not taken positive actions on the deficiencies, recommend other government actions such as suspension or disapproval of costs generated by the inadequate portion of the system or the entire system.

b. Many major government contracts contain clauses requiring an approved cost/schedule control (C/SC) system meeting DoDI 5000.2 criteria for performance measurement on selected acquisitions (11-200). If the contractor has contracts requiring an approved C/SC system, provide an assessment of whether the deficiencies disclosed in reports on material management and accounting systems, labor, other accounting systems, forward pricing rates, budgets, and billing systems are likely to materially affect the reliability of the contractor's C/SC system. Discuss findings and recommendations relating to the C/SC system with the Contract Administration Office C/SC monitor and the audit supervisor prior to issuance of the report. Immediately after issuing the report, the auditor should evaluate the impact of these deficiencies on specific contracts requiring an approved C/SC system and where significant provide the details in C/SC systems surveillance reports (11-209.2e). For example, the systems report might say:

"We believe the deficiencies noted in this report will have a material impact on the reliability of the contractor's cost/schedule control (C/SC) system and on the accuracy of the system's data. Immediately after issuing this report, we will evaluate these deficiencies to determine the impact on specific contracts requiring an approved C/SC system and will provide the details in C/SC systems surveillance reports."

c. Set forth the results of the exit conference with designated company representatives where the results of audit and statement of conditions and recommendations were presented. This section should state that the findings, such as noncompliances, system deficiencies, cost avoidances, or cost impacts, were provided to the contractor and that its

responses were incorporated in the corresponding appendixes.

d. This section should also report the status of contractor efforts to correct previously reported conditions in the same area and it should state whether the auditor considers the corrective action adequate. If corrective action has not been taken or is inadequate, the recommendation should be restated and the updated discussion of the matter should be referenced in the present report.

e. Functional, operation, and accounting and management systems audits usually review parts of the contractor's system of internal controls rather than the entire system. As a result, the results of audit section should generally include the following paragraph:

"We examined only the [insert the function, operation, or accounting and management system reviewed]. Accordingly, we express no opinion on the contractor's system of internal controls taken as a whole."

10-409 Statement of Conditions and Recommendations

a. The statements of condition and recommendations are an integral part of the results of audit and should follow the narrative described in 10-408. The presentation should follow the six-element outline as noted below to present a logical statement of conditions and recommendations. The two main subheadings should be "Condition" and "Recommendation". Although the six elements of an audit finding should not be addressed under separate subheadings, they must be included as part of the statement of condition to present a logical, convincing case.

(1) Condition - This attribute identifies the nature of the deficiency, finding, or unsatisfactory condition by disclosing how things are.

(2) Criterion - This attribute establishes the legitimacy of the finding disclosing how things should be.

(3) Cause - This attribute gets to the root of the problem by answering the question, "Why did it happen?"

(4) Fact - Examples should be included to demonstrate to the contracting officials and contractor that the reported conditions do exist.

(5) Effect - This attribute convinces the reader that the condition is significant by answering the question, "What happened as a result of this condition? How was the government harmed?"

(6) Recommendation - This attribute suggests remedial action answering the question, "What must be done to eliminate the cause of the condition?" If the relationship between the cause and the condition is clear and logical, the recommended action(s) will most likely be feasible and appropriately directed.

b. Present a comprehensive condition statement for each significant deficiency or area susceptible to improvements in economy or efficiency. If possible, quantify the estimated annual savings to be realized by implementing the audit recommendation(s) to eliminate the deficiency. Also, if estimated annual savings is not relevant, provide an estimate of the costs affected by the deficiency.

c. The auditor's constructive, specific recommendation(s) should be stated immediately after each reported condition. Use a separate section labeled "Contractor's Reaction" to summarize the contractor's response to the condition and recommendation(s). Include the complete written response as an "attachment." If the contractor's comments warrant a rebuttal or rejoinder, include DCAA's argument in a section labeled "Auditor's Comments."

10-410 Contractor Organization and Systems

This section should furnish pertinent information necessary for the reader to understand the area reviewed. This information should be classified under separate subheadings for the organization and individual system(s) (e.g., accounting system, estimating system, labor system, etc.)

a. The ORGANIZATION subheading might include a description of contractor's organization, intercompany relationships, facilities, product lines and current operations, staffing levels, per-

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DCAA CONTRACT AUDIT MANUAL VOLUME 1 CHAPTERS 1 - 11 (U)
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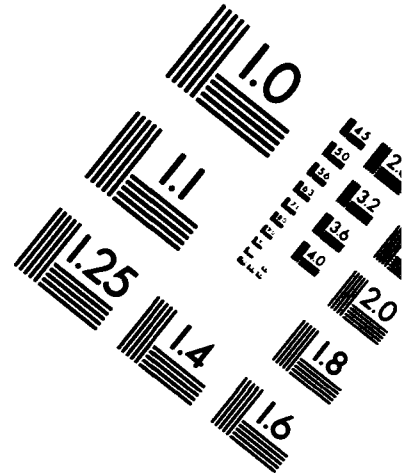
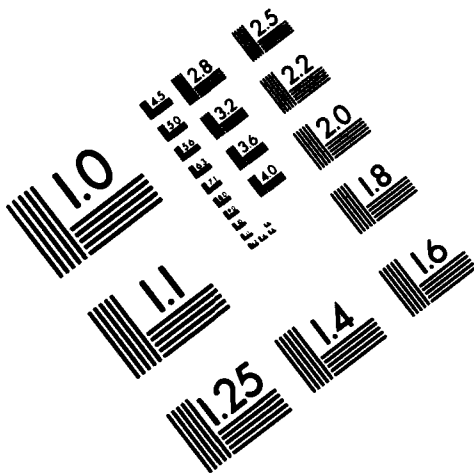




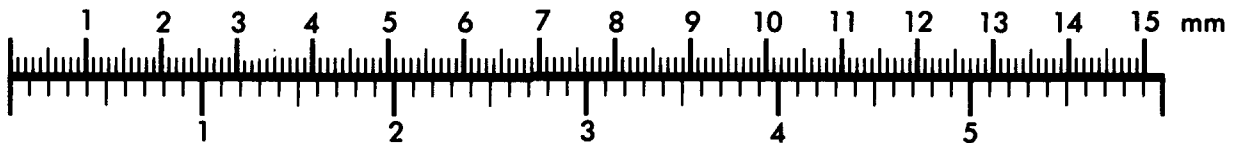
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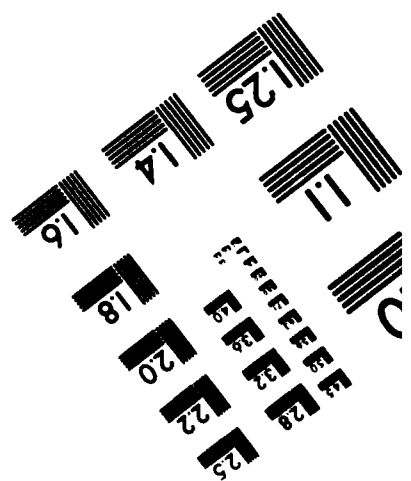
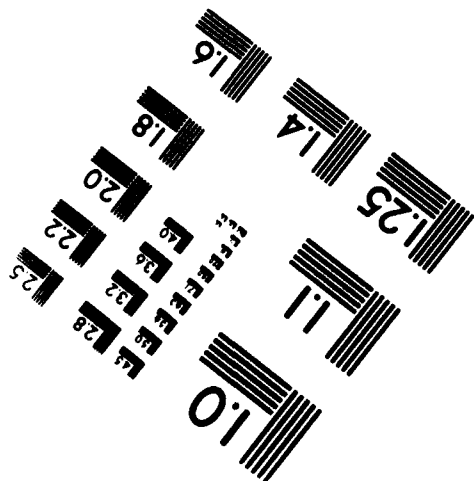
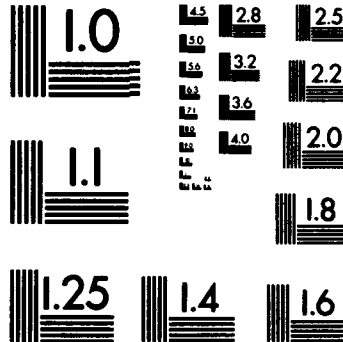
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centage of government participation and so forth.

b. For individual audits of accounting and management internal control systems this section should provide background on the system being reviewed. For example, background on the estimating system may read:

"ESTIMATING SYSTEM"

[insert contractor's name] has about 30 employees who work in the Estimating Department. The Estimating Department is responsible for preparing cost estimates used in individual price proposals, indirect expense rate forecasts, indirect departmental cost budgets, progress payment requests, and contract financial reports. [insert contractor's name] detailed estimating policies and procedures are described in its "Consolidated Estimating Manual." The last revision made to this manual was dated 31 July 199X.

During the last FY 199X, [insert contractor's name] submitted about \$750 million of price proposals to the government. Based on these proposals, [insert contractor's name] expects to obtain contract awards of about \$420 million.

c. For other financial related audits (e.g., incurred cost, proposal, progress payment, etc.), this section would provide the following information on the relevant accounting and management internal control systems that cover the area being audited:

- (1) the opinion on the adequacy [or inadequacy in part or in total],
- (2) our most recent internal control audit,
- (3) our assessment of control risk,
- (4) the impact of this risk on other related audits, and
- (5) the current status of outstanding system deficiencies and noncompliance issues.

The list of issues should be continuously updated to remove corrected deficiencies/noncompliances and add new ones. The cost impact of these issues affecting

the area being reviewed should be worked into the structured notes in the results of audit section. Each issue should also be updated on an ongoing basis to reflect the current status of corrective action. A sample paragraph for a contractor's estimating system may read:

"ESTIMATING SYSTEM"

"In our opinion, [insert contractor's name] estimating system and the related internal control policies and procedures are inadequate in some respects to ensure that proposals and final certified contract prices are based on accurate, complete, and current cost or pricing data. As a result of these deficiencies, the ACO disapproved the material portion of the estimating system on 1 January 199X. Our audit of [insert contractor's name] estimating system is discussed in Audit Report No. 3851-9XL24010131, dated 1 November 199X, previously provided to your office."

"In this audit we obtained an understanding of the estimating system internal control structure policies and procedures and determined that certain estimating methods are deficient. As a result of the following listed outstanding estimating deficiency, we assess the risk for overestimating material costs as high and have adjusted our audit scope accordingly."

"Outstanding Estimating Deficiencies"

"Deficiency: [insert contractor's name] does not have effective internal controls to ensure that proposed material costs are based on current vendor quotes, recent historical prices, or reflect vendor prompt payment or quantity discounts. As a result, proposed material costs are often overstated."

"Status: [insert contractor's name] agrees and is currently revising its estimating policies and procedures to correct this deficiency. After the policies and procedures have been

revised, training will be provided to all [insert contractor's name] estimators. [insert contractor's name] expects to complete these actions by 31 July 199X."

10-411 DCAA Personnel

a. Identify the contacts (i.e., the auditor, supervisory auditor and FAO manager) for further information regarding the audit. Include appropriate phone and FAX numbers.

b. "Audit Report Authorized By" is the signature block for the audit report. Show the signature authentication prescribed in 10-210. Joint reports prepared under a cost monitoring program will be signed by both the contract administration official and the branch manager or resident auditor.

10-412 Audit Report Distribution and Restrictions

a. All recipients of the audit report will be identified in this section of the report. Section 10-211 delineates the basic policy and instructions on distributing audit reports. In addition, report copies should be distributed as specified below to provide information that other officials may use in performing their respective duties. A transmittal letter should accompany all functional reports. It should not be construed as suggesting the need for assistance to the ACO in resolving the report recommendations. Audit report distribution requirements for non-DoD contractors are shown in Supplement 15-1S7. Non-DoD address lists for audit reports are presented in Supplements 15-1S1 through 15-1S6.

b. Audit report distribution restrictions should be listed in this section of the report. Follow the general guidance in 10-206, the wording illustrated in MRD 94-PFD-163(R), dated 26 September 1994, and the examples on the DCAA Bulletin Board System under the file name NUFORMAT.ZIP.

10-412.1 Distribution to Contractor

a. The ACO is responsible for formally notifying the contractor of the reported results of audit by forwarding the report

to the contractor (DFARS 242.7002-2(b)(1)).

b. Show the contractor on the report distribution list (10-211), using the parenthetical phrase "(thru the ACO)."

10-412.2 Distribution to Other In-Plant Government Representatives

Other government procurement activities have resident offices at some contractor facilities. They may include technical staff from the program office, requirements analysts from the logistics support office, and procuring contracting officers' representatives. Provide each such office a copy of any report which affects its area of the contractor's operation unless the office prefers not to receive such reports.

10-412.3 Distribution to Procurement Offices

a. Information copies of reports with significant findings should be sent to each procurement office doing substantial business with the contractor, unless an office's contracts would not be affected by the reported conditions. A report with significant findings is one that discloses one or more major deficiencies or recommends significant cost avoidance or contractor corrective action(s). A follow-up report should be distributed as a significant report if the prior report on the same subject contained significant findings.

b. Upon written request to the FAO, a procurement office may be added to or deleted from report distribution lists for a particular contractor without regard to the above criteria.

c. For distribution procedures related to team reports see 10-208.1.

10-412.4 Additional Distribution of Reports on Subcontractors

a. Some companies perform significant subcontracts under major procurement programs. In such cases report distribution should consider the information needs of the procurement office(s) involved. Apply the same criteria as for prime contractors (10-412.3 above). A report distributed to a procurement office because of subcontract rather than prime contract interest requires further distribution to each plant representa-

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tive/ACO at the related prime contractor and any intervening subcontractors.

b. When distribution to a procurement office is not warranted, consider whether the reported conditions may nevertheless be significant to the plant representative/ACO at the next higher-tier contractor doing substantial business with the subcontractor. An estimating system survey of a subcontractor (if significant deficiencies are involved) is an example of a report that would normally be of interest to government representatives at the next higher tier. Such reports are not intended for action by or release to the higher-tier contractors. Therefore, the cover sheet stipulation concerning release of subcontractor information (10-206.3) is not required. If a higher-tier plant representative/ACO or auditor believes that the contractor should be advised of a particular condition at the subcontractor, an assist audit request should be processed so that an appropriate report may be prepared for the contractor's use.

10-412.5 Distribution to Other DCAA Offices

When a report is distributed to one of the major buying commands with an on-site PLA (refer to 15-3S1), also distribute a copy to the PLA. For each higher-tier plant representative/ACO included on the distribution list for a report on a subcontractor, also distribute a copy to the auditor at the higher-tier contractor.

10-412.6 Additional Distribution of Estimating System Survey Reports

Provide one copy of estimating system survey reports to DCMC Headquarters

(DLA-AFS), Cameron Station, Alexandria, VA 22314.

10-412.7 Additional Distribution-NASA Contractors

If NASA contracts are subject to the functional review, one copy of the report should be sent to each of the NASA procurement centers which have current significant contracts with the subject contractor. See 15-1S2 for a listing of centers, which can be identified to the contractor's workload through the NASA contract code for each center. Major subcontract workload under NASA programs should also be considered (see 10-412.4).

A second copy should be sent to the Inspector General's Office responsible for the geographical area of the contractor (see 15-1S1). Provide additional distribution if requested by NASA officials. (Also see 15-106.)

10-413 Attachments

a. Attachments are stand alone documents which are not an integral part of the audit report. Such documents might include assist audits, technical reports, contractor responses, rate agreement letters, and so forth. Essentially, attachments are not prepared by the auditor during this audit - they contain related information which is valuable to the ACO and they are attached after the signature.

b. If there is only one attachment, it can be identified in the Contents section of the Cover Sheet. When we have several attachments, a separate Listing of Attachments should be added after the signature.

**10-4S1 SUPPLEMENT — OUTLINE OF
REPORT ON TEAM ESTIMATING SYSTEM SURVEY
OF THE
XYZ CORPORATION
PHILADELPHIA, PENNSYLVANIA**

1. Purpose and Scope of Audit

The opening paragraph should indicate that an audit was performed by government audit (and, if applicable, technical) personnel to evaluate the estimating methods and procedures used by the contractor in preparing price proposals for government contracts. This paragraph should also state the period of audit performance and identify the contract administration office which furnished the technical representatives. For example, a purpose paragraph may read:

As part of our audit of [contractor name, division/plant], we have evaluated the contractor's estimating methods and procedures used in preparing price proposals for government contracts. The objective was to obtain additional understanding of the flow of documents, including the availability and use of accounting, statistical, and budgetary data; and of the management controls and decision-making processes intended to ensure that accurate, complete, and current cost or pricing information is submitted at all phases of the negotiation process. [If appropriate add: Technical specialist assistance was provided by (contract administration office.)] The audit was conducted from [month/year] to [month/year].

The scope paragraph may read similarly to the following:

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records evaluated are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records evaluated. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall documentation of the estimating system. We believe that our audit provides a reasonable basis for our opinion.

Our audit specifically covered [modify the following as necessary to fit the circumstances of the audit]:

1. Organizational structure and assignment of responsibility
2. Policies, procedures, and other instructions
3. Internal controls and managerial reviews
4. Outside consulting or internal audit reports including training programs
5. Cost estimate development, including proposal format and underlying data and judgments supporting each cost element."

2. Circumstances Affecting the Audit

This section should also identify any significant limitations on the scope of the audit. Examples of limitations include lack of requested technical assistance, contractor delays in furnishing requested data or scheduling meetings, or the absence of written policies or other data on the system (see also 10-209.2).

3. Background Information

This section is intended to provide an overview of background information such as the contractor's operations, types of products, and volume of sales to the government. The volume of sales under various types of government contracts and the approximate number of pricing proposals submitted each year are particularly relevant.

4. Summary of Audit Results

a. This section should contain an overall opinion on the effectiveness of the contractor's estimating system and a recommendation to disapprove a portion or the entire estimating system (as appropriate). These statements should be based on the extent to which weaknesses or deficiencies affect the reliability of the contractor's cost estimates or hamper the effective evaluation of pricing proposals submitted for government contracts. Only significant estimating system deficiencies should be reported. If any significant deficiencies are cited, then the opinion paragraph must recommend disapproval of either a portion or the entire estimating system. Minor estimating deficiencies that, if corrected, would enhance the contractor's estimating system should be addressed in a separate appendix entitled "Suggestions for Improvement."

The report should include the estimated cost impact of each significant estimating deficiency. Calculation of the impact should be based on such factors as the amount of questioned and unsupported costs found in previous price proposal audits and the amount of recommended price adjustments found in previous postaward audits that are attributable to the estimating deficiency. It may also be appropriate to show such information as a comparison of estimated costs to subsequent actual costs if such information would reflect the degree of reliability of the contractor's estimates.

In addition, the summary should generally describe the nature of adverse conditions disclosed during defective pricing audits (10 U.S.C. 2306a) resulting from estimating system deficiencies. It should also contain an evaluation of the effectiveness of the contractor's procedures for furnishing the negotiator with updated proposal information during the period between the price proposal submission and final agreement on contract price.

If the system is generally adequate, the following statement would be appropriate:

In our opinion, the contractor's estimating system is generally adequate to ensure that proposals and final certified contract prices are based on accurate, complete, and current cost or pricing data. [If the system is generally adequate, but minor deficiencies exist, the deficiencies should be addressed as suggestions for improvement. In such a case, add: "Several suggestions for improvement that would enhance the contractor's estimating methods are included in a separate appendix to the report."]

If significant deficiencies exist which are likely to result in proposal estimates with one or a few major cost elements consistently unacceptable for negotiating fair and reasonable contract prices, the following statement may be appropriate:

In our opinion, the contractor's estimating system is, in some respects, inadequate to ensure that proposals and final certified contract prices are based on accurate, complete, and current cost or pricing data. [If appropriate, continue this opinion by showing total questioned and unsupported costs, and recommended price adjustments attributed to system weaknesses or deficiencies.] Accordingly, we recommend that the affected portions [if feasible, describe affected areas, e.g., inadequate policies and procedures, unrealistic budget forecast, and adequate estimates for direct labor] of the contractor's estimating system be disapproved. [If appropriate, recommend that the ACO consider notifying contracting activities that cost or pricing data on negotiated procurements should be requested at the \$100,000

level.] All significant deficiencies, affected cost elements, related recommendations for corrective action, and the contractor's response are detailed in the appendixes. [If minor deficiencies exist, they should be addressed as suggestions for improvement. In such a case, add: "We also have several additional suggestions for improvement that would further enhance the contractor's estimating methods as discussed in an appendix to this report."]

If deficiencies are so significant that the estimating system is likely to produce proposal estimates which in total are consistently unacceptable as a basis for negotiating fair and reasonable contract prices, the following statement may be appropriate:

In our opinion, the contractor's estimating system is inadequate to ensure that proposals and final certified contract prices are based on accurate, complete, and current cost or pricing data. [If appropriate, continue this opinion by showing total questioned and unsupported costs, and recommended price adjustments attributable to system weaknesses or deficiencies.] Accordingly, we recommend that the contractor's estimating system be disapproved. In addition, we recommend that the administrative contracting officer consider notifying contracting activities that cost or pricing data on negotiated procurements should be requested at the \$100,000 level. All significant deficiencies, affected cost elements, related recommendations for corrective action, and the contractor's response are detailed in the appendixes. [If minor deficiencies exist, they should be addressed as suggestions for improvement. In such a case, add: "We also have several additional suggestions for improvement that would further enhance the contractor's estimating methods as discussed in an appendix to this report."]

No matter what opinion is rendered (i.e., generally adequate, inadequate in some respects, or totally inadequate), the following statement will be inserted after the opinion paragraph:

Our audit was limited to the contractor's estimating methods and procedures. Accordingly, we express no opinion on the contractor's internal control structure taken as a whole.

b. If significant weaknesses or deficiencies are reported, include a statement that, whenever possible, the cost impact of the deficiency will be computed and described in the explanatory notes for all future proposal audit reports on each affected price proposal until the deficiency is corrected.

c. Significant weaknesses or deficiencies disclosed by the audit occasionally may be completely corrected during the audit, and the effectiveness of the corrective action verified. Such items should be addressed in this section of the report rather than in an appendix. Comments on such items should briefly describe the general nature of the problem and the contractor's corrective action, and should indicate that the problem was adequately resolved.

d. This section should also identify areas to be emphasized by government procurement and contract administration personnel reviewing and negotiating individual pricing proposals. These areas should generally correspond to the weaknesses noted during the audit.

e. This section will show the date of the exit conference and the names of the contractor's principal representatives in attendance, as follows:

The conditions and recommendations were discussed with [identify key contractor representatives] at the [date] exit conference. The contractor's written response has been incorporated into this report. [Or, if the contractor failed to furnish a written response within a reasonable time, state: "The contractor failed to provide a timely written response to our findings and recommendations. However, the contractor's

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response as obtained from the exit conference discussions has been incorporated into this report."]

f. Close this section with a cautionary note, as follows:

The information contained in this audit report should not be used for other purposes without first discussing its applicability with us.

5. Status of Corrective Action Taken on Prior Recommendations

This section should identify the contractor's corrective actions on recommendations made in prior audits and "real time" ("flash") reports. It should also refer to the applicable appendixes for open deficiencies and describe any problems encountered in obtaining contractor corrective action.

6. Disposition of Audit Results

If appropriate, this section will express appreciation for the contractor's cooperation. When a follow-up audit is contemplated (see 9-1114.5), state that within approximately six months a report will be issued on the status of the contractor's implementation of the audit report recommendations. (If the six-month time frame is not feasible for reasons described in 9-1114.5a, provide an approximate date for when the follow-up audit will be performed and the reason for the deferment. If a follow-up audit is not contemplated, indicate that a follow-up review will not be performed along with the reason.) Offer audit assistance to implement report recommendations. If a Contract Audit Follow-up Summary Sheet (see 15-600) is required to be attached to the original copy of the audit report, make reference to that fact. Other general comments may be made as appropriate. An example of a disposition of audit results section is as follows:

We will be pleased to provide accounting counsel and any additional audit service which the Administrative Contracting Officer may require in connection with this report and the implementation of our recommendations. Requests for assistance should be directed to [name], Supervisory Auditor, telephone number _____ or fax number _____.

We wish to express our appreciation for the contractor's cooperation during this audit.

Within approximately six months [or other date if follow-up will be done at an earlier or later date], we will issue a report on the status of the contractor's implementation of the audit recommendations.

We have attached to the original of this report a Contract Audit Follow-up Summary Sheet in accordance with reissued DoD Directive 7640.2 dated 12 February 1988.

DEFENSE CONTRACT AUDIT AGENCY

[Signature]

Thomas Powell, Branch Manager

DCAA Contract Audit Manual

Appendix — Statement of Conditions and Recommendations

a. Use a separate appendix for each detailed statement of condition and recommendation. A descriptive heading should be provided for each significant adverse condition disclosed by the audit. The presentation should follow the guidance in 10-413.

b. The "effect" of the condition should identify each cost element affected and address the overall impact on (1) the reliability of the contractor's cost estimates and (2) the government's ability to evaluate pricing proposals. When significant costs have been questioned or classified as unsupported in individual pricing proposals or recommended as price adjustments in postaward audits as a result of the particular deficiency or weakness, this should be stated. If feasible, the amounts questioned, classified as unsupported or recommended as price adjustments (including those resulting from Cost Accounting Standard (CAS) noncompliances) for an annual or semiannual period or for a specific number of proposals should be stated. Such information should be readily available from the experience information worksheets prepared during the preliminary audit effort.

c. If reported deficiencies have resulted in outstanding or repetitive CAS noncompliance reports, the condition statement should reference these reports and indicate the corrective action taken.

d. The contractor's reaction as obtained from its written reply to the draft statement of conditions and recommendations or from the exit conference discussions should be accurately summarized. In doing this, indicate the extent to which the contractor has agreed to take corrective action (for example, will correct or disagrees and the reasons for disagreement). If appropriate, comments regarding the current status of the contractor's corrective action may be included.

e. When new matters raised by the contractor's reaction can be effectively covered by a specific short response, a brief rejoinder or rebuttal may be included in a separate subparagraph entitled, "Auditor's Comments." However, this section should not be used merely to restate or amplify a position already presented in the statement of the condition or the recommendation.

Other Appendixes

1. Contractor's Organization and Products

This appendix should be used to present information not given in the "Background Information" section or to expand on that information.

2. Estimating Methods and Procedures

This appendix should concisely describe the contractor's estimating function, policies and procedures, and the methods employed in developing estimates for pricing proposals. Generally, the explanation should require no more than three or four pages and contain separate coverage for each major cost element and profit. When a previously issued report contained a description of the contractor's estimating function and no change has occurred, a reference to that report will suffice.

3. Suggestions for Improvement

This appendix should describe deficiencies that are not significant but whose correction would enhance the contractor's estimating system. Use the same format as the statement of conditions and recommendations appendix.

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**10-4S2 Supplement — Outline of
a Report on Estimating System Deficiencies
Reported Under the Real-Time Flash Reporting System
(Flash Report)**

1. Purpose and Scope of Audit

A statement similar to the following is appropriate for estimating system deficiencies disclosed during a price proposal audit:

"Our assessments of the contractor's estimating practices during price proposal audits include determining if the contractor uses estimating procedures which are consistently applied and ensure use of the most accurate, complete, and current cost or pricing data available at the time of proposal preparation. Consistent application of sound estimating procedures should reduce defective pricing and facilitate audit and evaluation of the contractor's proposals submitted in connection with government procurement actions."

A statement similar to the following is appropriate for estimating system deficiencies disclosed during a postaward audit:

"Our postaward audits of the contractor's cost or pricing data used in the initial pricing of its contracts include determining if defective pricing findings result from estimating system deficiencies. A contractor should use estimating procedures which are consistently applied and ensure use of the most accurate, complete, and current cost or pricing data available at the time of proposal preparation. Consistent application of sound estimating procedures should reduce defective pricing and facilitate the audit and evaluation of the contractor's proposals submitted in connection with government procurement actions."

The scope paragraph for any flash report should read similarly to the following:

"Our audits are performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform audits to obtain reasonable assurance about whether data and records examined are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records. An audit also includes assessing the accounting principles used and significant estimates made by the contractor. We believe that our audit provides a reasonable basis for our opinion."

2. Background Information

This paragraph should provide whatever data on the contractor's operations is needed to facilitate understanding of the estimating system deficiency(ies) being reported and the auditor's recommendations.

3. Summary of Audit Results

Paragraphs similar to the following are appropriate:

"In our opinion, certain contractor estimating practices used in preparing its proposal(s) submitted in connection with RFP/RFQ No. ____ (or in connection with the negotiation of modification no., contract no., etc.) (by parenthetical comment reference the audit report where the deficiency(ies) was/were found) require corrective action to improve the reliability of its future cost estimates."

"This report is limited to the cited deficiency(ies). Accordingly, we express no opinion on the adequacy of the contractor's internal control structure taken as a whole.

"Following is a summary of the deficiency(ies) noted, our recommended corrective action, and the contractor's response:"

a. Provide a separate presentation with a descriptive subparagraph caption for each significant deficiency identified. (For example, Failure to Use Accurate, Complete, and Current Data for Purposes of Estimating Material.)

(1) Condition. Adequately describe each estimating system deficiency to permit a thorough understanding of the situation. See 10-413 for additional information.

(2) Cost Impact. Provide an adequate explanation of the significance of the problem and, if applicable, disclose the cost impact of the deficiency on the price proposal or postaward audit evaluation.

(3) Recommendation(s). Offer a specific recommendation(s) for corrective action(s) along with a statement regarding any acceptable alternative(s) proposed by the contractor.

(4) Contractor's Reaction. Disclose any verbal or written contractor reaction to the issue(s) presented.

(5) Auditor's Comments. Offer any audit rejoinder to the contractor's reaction and response. If the contractor agrees with the cited condition, this subparagraph is not required.

Close this subparagraph with a cautionary note, as follows:

"The information in this report should not be used for other purposes without first discussing its applicability with us."

4. Disposition of Audit Results

Following is suggested wording for this section:

"We will be pleased to provide accounting counsel and any additional audit service which the Administrative Contacting Officer may require in connection with this report and the implementation of our recommendations. Direct requests for assistance to (name), Supervisory Auditor, at telephone number _____ or fax number _____."

"Within approximately six months [or other date if follow up will be done at an earlier or later date], we will issue a report on the status of the contractor's implementation of the audit recommendations."

10-500 Section 5 — Audit Reports on Annual Incurred Costs**10-501 Introduction**

a. This section presents guidance for preparing and distributing audit reports on final procurement-determined (FAR 42.705-1) and final audit-determined (FAR 42.705-2) indirect cost rates.

b. Results of the concurrent review of claimed direct costs will be reported in the audit report on annual indirect costs. Guidance on assist reports to other contract auditors is in 6-800.

10-502 Nature of Reports

a. Audit reports on indirect costs are designed to furnish audit information and recommendations on the allowability of costs and rates for settlement purposes and to provide support for establishment of final indirect cost rates. In order to initiate the waiting period for the contractor's response, all audit findings applicable to a fiscal period must be summarized in a single audit report. This does not preclude issuance of reports on significant system deficiencies, CAS/FAR noncompliances, or reports required to support timely issuance of DCAA Forms 1 (see 6-708b, 6-709b, and 6-900). Also, the auditor should be discussing significant audit findings with the contractor during the audit to expedite the resolution process. Multi-year audit reports must clearly segregate all findings by fiscal period.

b. When direct costs are reviewed concurrently with the indirect costs, any questioned or disallowed direct costs will be included in the audit report. However, such reporting does not replace the issuance of the following:

(1) Notices of Costs Suspended and/or Disapproved (6-900).

(2) Audit reports on individual FPR/FPI price redetermination proposals (10-300).

(3) Final audit reports on individual cost-reimbursement type contracts and subcontracts (10-900).

(4) Interim assist audit reports to the upper-tier auditor when needed (6-800).

c. The audit report cannot be issued before the completion of the required field work and the final exit conference. Required field work includes audit procedures and tests judged necessary by the auditors, and prescribed by generally accepted government auditing standards and MAARs. Therefore, the audit report will not, as a rule, contain qualified opinions or unresolved costs (see 10-504.1 for comments on scope).

10-503 Format and Content of Reports

a. Prepare the report in the format given in 10-200. It should be addressed to the contracting officer, and should include the information required by FAR 42.705-1(b)(2). The extent of detail to be included in the report exhibits and schedules should be governed by the materiality of the indirect cost pools, the government's participation, and the amount of questioned costs. A complete pro forma report for nonmajor contractors is included in the DIIS audit guidance as "NMARINCR." Examples of report exhibits are also included in Figures 10-5-1 and 10-5-2.

b. If the audit of the contractor's proposal discloses no items of questioned costs or if the amounts disclosed are insignificant, you may use a short form report as described in 10-218, provided the contracting officer has not specifically requested more detailed information. Include sufficient indirect cost and rate data in the short form report to provide the reader with an understanding of how the audit results were achieved. Including such data should also enable the negotiator to prepare the negotiation report when required. If costs were questioned, include at least the following items in the explanatory notes:

(1) Background information including a description of the nature of the proposed costs.

(2) The basis for the questioned costs including a description of the questioned costs, details on the calculation of questioned costs, and a specific reference to

the regulatory support such as the cost principle, cost accounting standards, or contract terms.

(3) A statement that the contractor either agreed or disagreed with the questioned costs and the basis for any disagreement.

(4) The auditor's reaction, if the contractor disagrees with the questioned costs.

(5) If any contracts containing the DFARS clause 252.231-7001 were active in the period, the classification of questioned costs with respect to the penalty provisions of DFARS 252.231-7001 (6-608.4).

If the contractor concurs in the questioned costs, use auditor judgment on the extent of explanation needed to describe the questioned costs.

c. If the audit report covers audit-determined rates and the contractor agrees with the audit findings, enclose a copy of the completed indirect cost rate agreement required by FAR 42.705-2(b)(2) with the audit report. In addition, include a specific reference to the attached indirect cost rate agreement in the narrative body of the report.

d. Keep the ACO informed of significant issues which may ultimately require his or her action to resolve. If the contractor does not concur in the audit-determined rates, follow the procedures in 6-900 and prepare the audit report only after having coordinated with the ACO to ensure consideration of all information bearing on the area of nonconcurrence. If it appears that the contractor will not agree with the findings, provide the ACO with written documentation of the results of audit which will be communicated to the contractor at the final exit conference. In addition, provide the ACO with a copy of the contractor's written rebuttal to the audit findings immediately upon receipt. In preparing the audit report, include the following categories of costs in the exhibits for each cost pool:

- (1) Total Indirect Costs
- (2) Unclaimed Costs
- (3) Claimed Costs
- (4) Total Questioned Costs
- (5) Questioned Costs (Concurred)

(6) Questioned Costs (Nonconcurred) (Attach DCAA Forms 1) if rates are audit determined)

Ensure that the audit report is issued within 60 days from the date the contractor's rebuttal comments are received. Enclose copies of applicable DCAA Forms 1 with the audit report and include a specific reference to the attached DCAA Forms 1 in the narrative body of the report.

e. In keeping with the guidance in 10-200 and subject to a. through d. above, the report will consist of a narrative section, accompanying exhibits and schedules, appendixes, and attachments assembled in the following sequence:

Narrative

Purpose and Scope of Audit

Circumstances Affecting the Audit (if applicable)

Contractor's Internal Control Structure

Summary of Audit Results

Disposition of Audit Results

Table of Contents

Exhibits and Schedules

Indirect Costs

Direct Costs Questioned (if applicable)

Indirect Costs Subject to Penalty

Exhibit of Contracts (with annotations to those contracts that include the penalty clause)

Schedule Listing Allowable Costs by Contract (if not practical, see 10-505g)

Exhibit of Contractor's Direct/Indirect Classification Policy (as applicable)

Appendixes (as applicable)

Contractor's Accounting System

Special Comments

Billing Rates

Attachments (as applicable)

DCAA Forms 1

Indirect Cost Rate Agreement

Certificate of Indirect Cost

Assist Audit Reports

Contractor's Response

10-504 Narrative Section

10-504.1 Purpose and Scope of Audit

a. This section should identify the period audited and the purposes of the audit.

Example 1 (Final Procurement-determined Indirect Cost Rates):

"We have audited the XYZ Company's books and records and its 20 December 1988 proposal for the purposes of recommending final procurement-determined indirect cost rates for 1 October 1987 through 30 September 1988, and of evaluating direct costs incurred under government flexibly priced contracts. The proposed rates apply primarily to the cost-reimbursement type contracts listed in Exhibit D. The proposal, previously furnished your office, sets forth the indirect costs and rates claimed to have been incurred in the performance of these contracts. This report presents our conclusions and recommendations on the indirect cost rates proposed by the contractor and the results of our review of direct costs."

"The submission is the responsibility of the contractor. Our responsibility is to express an opinion based on our audit."

Example 2 (Final Audit-determined Indirect Cost Rates):

"We have audited the XYZ Company's books and records and its 20 December 1988 proposal for the purposes of establishing final audit determined indirect cost rates for 1 October 1987 through 30 September 1988, and of evaluating direct costs incurred under government flexibly priced contracts. The proposed rates apply primarily to the cost-reimbursement type contracts listed in Exhibit D. The proposal, previously furnished your office, sets forth the indirect costs and rates claimed to have been incurred in the performance of these contracts. This report presents our final audit determination on the indirect cost rates proposed by the contractor and the results of our review of direct costs."

"The submission is the responsibility of the contractor. Our responsibility

is to express an opinion based on our audit."

b. Also use this section to detail the scope of the audit or any scope limitations regardless of which paragraph in 10-504.1a is used. The standard scope of audit statement is discussed in 10-209.1. If the concurrent MAARs were considered necessary to complete the audit but could not be accomplished for the period reviewed (6-104.4), qualify the scope paragraph by adding to or replacing "except as noted in paragraph 2," with "except as noted below." Insert the following additional subparagraph:

"The concurrent verification of (indicate whether labor, materials or both) was omitted in this review (if accomplished in at least one year of a multi-year review, state fiscal years omitted)."

10-504.2 Circumstances Affecting the Audit

a. Identify any circumstances encountered which have a significant adverse effect on the audit or results. (See 10-209.2 for general guidance and 6-708.1 and 6-709.2 for specific limitations.)

b. If the incurred cost audit report is issued before receipt of the assist audits on subcontract or intercompany costs, as discussed in 6-709.2c, the following information should be included in a report note or schedule for each unresolved subcontract/intercompany order.

- subcontract/intercompany order number
- subcontract/intercompany name
- subcontract/intercompany billed/claimed amount for the year
- date assist audit requested
- name of the audit office performing the assist audit
- expected assist audit report date

c. The unaudited subcontract/intercompany costs would be classified as unresolved in the report, pending receipt of the assist audits. The report should also say that upon receipt of the assist audit report, the recommended subcontract/intercompany costs included in the report will be reconciled with the related costs in the upper tier contractor's

incurred cost submission, and supplemental reports will be issued as required.

10-504.3 Contractor's Internal Control Structure

This paragraph should include information on the auditor's understanding of the internal control structure, assessment of control risk, and any reportable conditions. The pro forma report for nonmajor contractors included in the DIIS audit guidance as "NMARINCR" shows examples where control risk has been assessed both at maximum and at less than maximum.

10-504.4 Summary of Audit Results

Detail the major findings of the indirect and direct cost audit in this paragraph. When exhibits, schedules, or appendixes are used to fully develop the audit position, include a statement as follows:

"The audit results and recommendations are presented in the exhibits, schedules, and appendixes of this report."

If agreement is not reached on all issues, refer to the guidance in 10-503d.

a. Indirect Rates

Example 1 (Indirect rates accepted as proposed.)

"Indirect Rates. Our audit did not find any exceptions to the contractor's proposed indirect rates."

Example 2 (The auditor's indirect rate adjustments were accepted by the contractor.)

"Indirect rates. We have questioned \$_____ of the proposed _____ overhead expenses and \$_____ of the proposed G&A expenses. [Briefly describe the reasons for the major cost exceptions.] The audit results and recommendations are presented in Exhibits, schedules, and appendixes of this report. The enclosed Indirect Cost Rate Agreement documents the contractor's concurrence with our findings and recommendations."

Example 3 (The auditor's indirect rate adjustments were not accepted by the contractor.)

"Indirect rates. We have questioned \$_____ of the proposed _____ overhead expenses and \$_____ of the proposed G&A expenses. [Briefly describe the reasons for the major cost exceptions.] The audit results and recommendations are presented in Exhibits, schedules, and appendixes.

The contractor did not accept our findings and recommendations with respect to [state major areas of disagreement]. [If audit-determined rates, include the following sentence:] The amounts disapproved are set out in the attached DCAA Form(s) 1."

b. Direct costs

Example 1 (No direct costs questioned.)

"Direct Costs. Our audit of direct costs disclosed no exceptions at this time and they are provisionally approved pending final acceptance. Final acceptance of amounts proposed under government contracts does not take place until performance under the contract is completed and accepted by the cognizant authorities and the audit responsibilities have been completed."

Example 2 (Direct costs questioned.)

"Direct Costs. We questioned \$_____ of direct costs proposed under government contracts. [Briefly describe the reasons for the major cost exceptions.] Questioned direct costs by element within specific contracts are presented in Exhibit. Direct costs not questioned are provisionally approved pending final acceptance. Final acceptance of amounts proposed under government contracts does not take place until performance under the contract is completed and accepted by the cognizant authorities and the audit responsibilities have been completed."

c. Indirect Costs Subject to Penalty

Include this paragraph when contracts containing the DFARS clause 252.231-7001 were active in the period and indirect costs are questioned (6-608.4).

Example 1 (No questioned costs are subject to the penalty.)

"Penalties for Unallowable Costs. None of the indirect costs questioned in this audit appear to be subject to the penalties provided in DFARS 252.231-7001."

Example 2 (Questioned costs are subject to the penalty.)

"Penalties for Unallowable Costs. Indirect costs questioned in this audit are believed to be subject to the penalties provided in DFARS 252.231-7001. Our recommendations for each questioned item are included in the notes to Exhibit(s) _____ and their supporting schedules. Affected contracts are identified in Exhibit _____. Our recommendations concerning the interest to be recovered on unallowable costs paid will be furnished when we have received your determination on penalties to be assessed."

d. State the name and title of the contractor's designated representative(s) with whom the audit findings were discussed as required by 4-300. Summarize the contractor's overall reaction and any major differences.

e. See 10-209.4 for other requirements related to this portion of the report narrative.

10-504.5 Disposition of Audit Results

a. Include this paragraph to comment on any of the following which are attached to the report and not discussed in the summary of audit results paragraph above: (1) DCAA Forms 1, (2) Indirect Cost Rate Agreements, or (3) Certificates of Indirect Costs. When discussing Forms 1, include an affirmative statement that the ACO was advised of the areas of disagreement which led to their issuance.

b. Also, as applicable, include a paragraph to state that the contractor has an approved CAS disclosure statement on

file. If the contractor does not have an approved CAS Disclosure Statement, or is not CAS covered, the appendix on the contractor's accounting system should be attached and referred to in this paragraph.

c. Inform the contracting officer that further advice and assistance can be obtained (1) by contacting the office issuing the report (include the FAO telephone and fax numbers), or, when applicable, (2) by contacting the on-site procurement liaison auditor (include the PLA's name, telephone number, and office location as shown in 15-3S1). Offer to provide accounting counsel and any additional audit assistance the contracting officer may require.

d. If questioned costs are believed to be subject to the DFARS 252.231-7001 penalties, request that the contracting officer's decision be furnished promptly.

e. If the complexity of the proposal or audit results warrant, recommend that the auditor be invited to attend the negotiation conference on procurement determined rates.

f. For procurement-determined indirect cost rates include in this section a request for the contracting officer to furnish a copy of the negotiation agreement as required by FBAR 42.706(b).

10-504.6 Signature Block

Conclude the narrative portion of the report with the signature authentication prescribed in 10-210.

10-505 Exhibits and Schedules

a. The report should contain all exhibits and supporting schedules required for a clear, complete presentation of the audit results. The specific procedures for achieving this reporting standard follow.

b. Except when a short form report is used (10-218), summarize the results of audit in Exhibit A, showing the amount and rate for each indirect pool as proposed by the contractor and as questioned by the auditor. Include a table in this exhibit showing the extent of government participation in the contractor's indirect allocation bases. An illustrative Exhibit A is shown in Figure 10-5-1.

c. Detail the audit results for each indirect cost rate classification in separate exhibits, with supporting schedules as required. An illustrative exhibit is shown in Figure 10-5-2. Modify the presentation to accommodate complex rate determinations and negotiation problems. Questioned costs should be supported by explanatory notes, which include the items discussed in 10-503b. The auditor can briefly describe the reasons for the questioned costs in those instances when the contractor concurs. When advance agreements or special provisions governing specific contracts are in effect, reference the Special Comments Appendix (10-506.2) in the explanatory notes associated with the applicable costs. Cross-reference the exhibits, schedules, appendixes, and, when appropriate, the narrative portion of the report.

d. If direct costs are questioned, include an exhibit summarizing the results of the audit of direct costs. Questioned direct costs should be supported by explanatory notes, which include the items discussed in 10-503b. The auditor can briefly describe the reasons for the questioned costs in those instances when the contractor concurs. Questioned amounts should be identified by procuring office, by contract, and by cost element.

e. If the contractor's submission applies to contracts containing the DFARS penalty clause and costs are questioned during the audit, include a schedule iden-

tifying questioned costs within pools by penalty class, amount, and percent of base subject to penalty (see Figure 10-5-3). For corporate home office expenses, the schedule should also include the allocable share for each division (see Figure 10-5-4).

f. Include an exhibit listing all government cost-reimbursement and flexibly priced contracts and subcontracts performed during the fiscal period. Indicate those contracts and subcontracts with advance agreements or governed by special provisions. Contracts containing the DFARS "Penalties for Unallowable Costs" clause must be identified through a footnote. Request the contractor to furnish the complete exhibit or the necessary information subject to your selective verification. Group the contracts by military departments or other government agencies concerned. Identify prime contracts and subcontracts by number and reference subcontracts to the prime contractor and prime contract number.

g. Include a schedule showing the allowable costs by contract or subcontract. If not practical (e.g., if the schedule would be too voluminous), make reference to the specific records that detail the allowable costs by contract and subcontract. (Note that the Indirect Cost Rate Agreement letter also includes this schedule as an enclosure, when practical; see 6-708.2c.)

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Figure 10-5-3, (Ref. 10-505(e))
**SCHEDULE OF UNALLOWABLE COSTS
SUBJECT TO PENALTIES**

Audit Report No. _____ Schedule _____

Sunshine Widget Company
Miami, Florida

SCHEDULE OF UNALLOWABLE COSTS SUBJECT TO PENALTY
Period _____ Through _____

Amount Subject to DFARS 231.7001

<u>Cost Element</u>	<u>Questioned Costs</u>	<u>Level One Penalty</u>	<u>Level Two Penalty</u>	<u>Reference</u>
Engineering Overhead:				
Consultants	\$150,000	\$100,000		***SEE NOTE BELOW***
Depreciation	100,000	100,000		
Pension	100,000	100,000		
Relocation	100,000	50,000		
Legal Fees	80,000	40,000		
Professional Actv.	80,000	80,000		
Travel	75,000	20,000		
Insurance	25,000	25,000		
Entertainment	25,000	25,000		
Totals	<u>\$735,000</u>	<u>\$540,000</u>		

Participation of Contracts with Penalty Clause

	<u>Total</u>	<u>With Clause</u>	<u>No Clause</u>
Allocation Base	\$40,000,000	\$8,000,000	\$32,000,000
Percent of Base	100.0%	20.0%	80.0%

Questioned Costs Subject to Level One Penalty (\$540,000 x 20%) \$108,000

Questioned Costs Subject to Level Two Penalty \$0

***NOTE: INCLUDE REFERENCES TO NOTES IN THE EXHIBIT CONTAINING THE PENALTY INFORMATION AS DISCUSSED IN CAM 10-505. AN EXAMPLE OF THE INFORMATION THE NOTES SHOULD CONTAIN IS INCLUDED ON THE DIIS UNDER NMARINCR.

Figure 10-5-4, (Ref. 10-505(e))
HOME OFFICE EXPENSE
SCHEDULE OF UNALLOWABLE COST SUBJECT TO PENALTIES

Audit Report No. _____ Schedule _____

San Juan Motor Works Home Office
Bellingham, Washington
SCHEDULE OF UNALLOWABLE COSTS SUBJECT TO PENALTY
Period _____ Through _____

Cost Element	Amount Subject to DFARS 231.7001			Reference
	Questioned Costs	Level One Penalty	Level Two Penalty	
Consultants	\$500,000	\$300,000		***SEE NOTE BELOW***
Lobbying	150,000	150,000		
Advertising	100,000	100,000		
Public Relations	100,000	100,000		
Relocation	80,000	40,000		
Travel	50,000	20,000		
Total	<u>\$980,000</u>	<u>\$710,000</u>		

Allocation to Divisions

<u>DIVISION</u>	<u>% ALLOCABLE</u>	<u>AMOUNT</u>
Missile	60%	\$426,000
Submarine	20%	142,000
Service Co.	10%	71,000
Research	10%	71,000
Total	<u>100%</u>	<u>\$710,000</u>

***NOTE: INCLUDE REFERENCES TO NOTES IN THE EXHIBIT CONTAINING THE PENALTY INFORMATION AS DISCUSSED IN CAM 10-505. AN EXAMPLE OF THE INFORMATION THE NOTES SHOULD CONTAIN IS INCLUDED ON THE DIIS UNDER NMARINCR.

10-506 Appendixes

Use appendixes as applicable to provide information and comments as described in the following paragraphs.

10-506.1 Appendix - Contractor's Accounting System

Use this appendix for contractors which have not submitted CAS disclosure statements or whose CAS disclosure

statements have not been approved. For those contractors with an approved CAS disclosure statement on file, include a comment to that effect in the narrative body of the report (10-504.5). Limit the description of the accounting system to the methods used for accumulating and allocating indirect costs to government contracts and other work of the contractor. Typically, this would consist of a listing of the various indirect cost pools

with brief explanations of their composition and of the related bases for allocation. Describe any significant change in indirect cost accounting and allocation methods made by the contractor since the prior audit, and your conclusions as to the propriety of the change. Any significant departure from prior policy should be discussed in the "Special Comments" Appendix.

10-506.2 Appendix - Special Comments

Use an appendix with this title to present any additional information which cannot be conveniently included in the exhibits and schedules, and to cover any other matters which warrant the attention of the contracting officer. Use this appendix to describe any advance agreements and special provisions governing specific contracts as required by FAR 42.705-1(b)(2), unless this information is identified in the exhibit required by 10-505g. Examples of other items which may be presented are:

- a. The effectiveness of the contractor's procedures and controls for excluding unallowable charges from its indirect costs claim.
- b. Management decisions resulting in the incurrence of unwarranted or unreasonable costs on contracts. This would include the results of any DCAA operations audits which affect the indirect cost rate claim.
- c. Changes in the contractor's accounting policy and practices for classifying direct or indirect costs when the changes result in inequitable or inconsistent cost determinations.

10-506.3 Appendix - Billing Rates

A billing rates appendix may be used to recommend billing rates when the indirect rates are procurement-determined, or to establish billing rates when the indirect rates are audit-determined (FAR 42.704). Identify the period to which the recommended rates apply. Comments supporting the recommended rates should mention whatever factors you considered, such as cost trends, changes in production volume, and shifts in areas of activity. The recommended rates should provide that the contractor will

not be reimbursed for unallowable costs (see 6-705.1).

10-507 Attachments

The report should include the following attachments as applicable: DCAA Forms 1, Indirect Cost Rate Agreement, Certificate of Indirect Cost, assist audit reports, and contractor written comments to the audit results.

10-508 Distribution of Incurred Cost Reports

a. Procurement-determined Indirect Costs. If the final indirect rates are to be procurement-determined, furnish the contracting officer (CACO or ACO) responsible for the negotiation of the final indirect cost rates an original and two copies of the audit report.

b. Audit-determined Indirect Costs. If the final indirect rates are to be audit determined, furnish one copy of the report to both the CACO, if assigned, and the ACO.

Distribute one copy of the report to the following:

- (1) Other DoD contracting officers or procurement officers administering a significant portion of the contractor's total government business.
- (2) The contract audit coordinator, if any.
- (3) When applicable, the on-site PLA (refer to 15-3S1) who provides service to the contracting officer responsible for the negotiation of the final indirect cost rate.
- (4) Upon specific request, other organizations consistent with 10-206 and the restrictions on the cover sheet (Figure 10-2-1).

c. Non-DoD Organizations: When specifically requested or if the procurement office has a significant portion of the contractor's total government business, distribute a copy of the incurred cost audit report to non-DoD organizations as shown below:

- (1) National Aeronautics and Space Administration (NASA).
 - (i) NASA Contractors (see 10-211);
 - (ii) NASA field audit office (Office

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- of Inspector General) cognizant of the geographical area in which contractor is located (see Supplement 15-1S1) — one copy.
- (iii) NASA field audit office (Office of Inspector General) cognizant of the Procurement Center responsible for the contract (see Supplement 15-1S1) — one copy.
- (iv) NASA Procurement Contracting Officer(s) at NASA Procurement Center(s) (see Supplement 15-1S2) doing business with the contractor — one copy.
- (v) Local NASA contract administration office (if any) — one copy.
- (2) Department of Transportation (see Supplement 15-1S5).
- (3) Department of Agriculture (see Supplement 15-1S6).
- (4) Department of Health and Human Services, Regional Audit Director — three copies (see Supplement 15-1S3).
- (5) Department of Housing and Urban Development Director — two copies to:
Headquarters Audit Operations
Office of Audit
Office of Inspector General
DHUD 451 7th Street, SW
Washington, DC 20410.
- (6) Environmental Protection Agency
Audit Division Director — two copies (see Supplement 15-1S4).

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Figure 10-5-1

Figure 10-5-1
Incurred Cost Summary Exhibit

Audit Report No. _____

EXHIBIT A
Page 1 of XX

XYZ Company
Philadelphia Pennsylvania
SUMMARY RESULTS OF AUDIT
Period 1 October 19XX through 30 September 19XX

Indirect Category	Claimed By Contractor		Questioned By Auditor		Reference
	Expense Pool	Indirect Cost Rate	Expense Pool	Indirect Cost Rate	
Factory Overhead (a)	\$ 853,960	\$ 4.512	\$26,950	\$.273	Exh B
Engineering Overhead (a)	460,500	\$ 5.169	15,322	\$.172	Exh C
General & Administrative Expenses (b)	320,384	8.0%	44,053	1.1%	Exh D
	<u>\$1,634,844</u>		<u>\$86,325</u>		

(a) Allocation Base—direct labor hours

(b) Allocation Base—total incurred costs, excluding G&A expenses (input costs)

GOVERNMENT PARTICIPATION IN ALLOCATION BASES

Contract Type In Allocation Base	Indirect Expense Pool		
	Factory	Engineering	G&A
Government cost-reimbursement contracts*	60%	78%	82%
Government flexible fixed-price contracts*	25	13	10
Government firm fixed-priced contracts*	10	5	4
Commercial work	5	4	4
	<u>100%</u>	<u>100%</u>	<u>100%</u>

*Includes Subcontracts

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Figure 10-5-2

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Figure 10-5-2 (Ref. 10-505)
Overhead Exhibit For A Specific Cost Rate

Audit Report No. _____

EXHIBIT B
Page 1 of 4

XYZ Company
Philadelphia Pennsylvania
STATEMENT OF CONTRACTOR'S CLAIMED FACTORY
OVERHEAD COSTS AND RESULTS OF AUDIT
Period 1 October 19XX through 30 September 19XX

Cost Element	Contractor's Overhead Costs			Results of Audit			Reference
	Total	Un-claimed	Claimed	Total	Concurred	Non-concurred	
Indirect Labor	\$410,000	\$3,000	\$407,000	\$(10,000)	\$(10,000)	—	Note 1
Home Office Expense	23,925	—	23,925	—	—	—	
Overtime Premium - Direct Labor	60,000	—	60,000	—	—	—	
Overtime Premium - Indirect Labor	35,000	—	35,000	—	—	—	
Payroll taxes	60,325	—	60,325	—	—	—	
Insurance	6,000	—	6,000	—	—	—	
Maintenance	23,000	—	23,000	10,000	10,000	—	Note 2
Depreciation - Equipment	43,000	—	43,000	(1,000)	(1,000)	—	Note 3
Rental of Buildings	92,000	—	92,000	—	—	—	
Utilities	44,000	—	44,000	—	—	—	
Manufacturing Supplies	18,000	—	18,000	4,000	—	\$4,000	Note 4
Licenses and Taxes	27,000	—	27,000	18,000	18,000	—	Note 5
Traveling Expense	11,000	—	11,000	2,700	—	2,700	Note 6
Entertainment	2,000	2,000	—	—	—	—	
Employment Expenses	3,710	—	3,710	3,250	1,000	2,250	Note 7
Totals	<u>\$858,960</u>	<u>\$5,000</u>	<u>\$853,960</u>	<u>\$26,950</u>	<u>\$18,000</u>	<u>\$8,950</u>	
Allocation Base							
Direct labor Hours			<u>189,264</u>	<u>(5,850)</u>		<u>(5,850)</u>	Note 8
Factory Overhead Rates:							
Proposed			\$ 4.512				
Questioned Due to Base				\$.135	—	\$.135	
Questioned Due to Costs				.138	\$.095	.043	
Unresolved				—	—	—	
Total Exceptions				<u>\$.273</u>	<u>\$.095</u>	<u>\$.178</u>	

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Figure 10-5-2

Explanatory Notes

1. Indirect Labor

The negative \$10,000 questioned represents 2,150 hours of inspection labor. The contractor charged these hours to various government jobs as direct labor based on estimates. Inspection labor for the contractor's commercial products, however, is included in factory overhead. During our audit we could not find a basis for this difference in treatment. The inspectors performing the work are unable to maintain detailed time records of the time they spend on the individual jobs. Because the contractor has neither basis nor the time records to sustain charging inspection labor to the government contracts as direct labor, and because commercial products are similar to those produced under government contracts, we reclassified the 2,150 hours as indirect and included them in factory overhead. (Also see note 8 below.)

The contractor concurs in our recommendation for this item. Because this upward adjustment is a reclassification of an otherwise allowable cost not previously determined to be misclassified, it is not subject to penalty under the provisions of DFARS 231.70.

2. Maintenance

The \$10,000 questioned represents the cost of a used milling machine purchased 1 April 19XX. This purchase was properly a capital expenditure under the contractor's capitalization policy, but was inadvertently charged to maintenance expense. We questioned the amount charged to maintenance expense, but allowed depreciation expense of \$1,000 for this year (see note 3 below).

The contractor concurs in our recommendation for this item. The difference between purchase cost and allowable depreciation is not assignable to this accounting period because it is in noncompliance with CAS 409.40(a) and is expressly unallowable in accordance with FAR 31.205-24(b). The cost is therefore subject to penalty under the provisions of DFARS 231.7002-1(a)(1).

3. Depreciation—equipment

Government technical personnel established a five-year life for the used milling machine which had been charged to maintenance expense (see note 2 above). Depreciation expense of \$1,000 was calculated using the straight-line method consistent with the contractor's depreciation policy. The calculation is as follows:

Cost basis	\$10,000
Divided by asset life	5 years
Annual expense	\$ 2,000
Allocation for partial year	50%
Depreciation expense	\$ 1,000

4. Manufacturing supplies

The \$4,000 questioned represents the cost of pyrotechnics used in surveillance testing. This amount of materials should be charged to the materials overhead pool, which includes quality control costs, in accordance with the contractor's established policy regarding material. Consequently, we have questioned these material costs and transferred a corresponding amount to the materials pool in Exhibit D.

The contractor does not concur in our recommendation, stating that its policy on materials does not apply to this pyrotechnic testing material. The contractor has not provided verifiable documentation to support its different treatment of testing material.

The amount questioned is a reallocation of an otherwise allowable cost. We notified the contractor by letter dated XX March 19xx that these costs were not allocable to direct labor hours. The contractor responded by agreeing to revisions of the estimating and billing rates. The referenced correspondence was previously furnished to your office.

These costs are now mutually agreed to be unallowable, as defined in FAR 31.201-6a, in the labor overhead pool. They are therefore subject to penalty under the provisions of DFARS 231.7001(a)(2).

5. Licenses and taxes

The \$18,000 questioned represents personal property tax on equipment used by a subsidiary which has no government contracts. These costs must be charged directly to the benefiting division in accordance with the requirements of CAS 403.40(a)(4) and 410.50(a). The contractor concurs in our recommendation on this item.

These costs are unallowable under FAR 31.205-41(b)(5). They are therefore subject to penalty under the provisions of DFARS 231.7002-1(a)(1).

6. Traveling expense

The amount questioned represents excess of first-class air fares over lower-class fares on various trips during the period. The contractor's policy requires the use of the most economical means of transportation available unless the urgency of travel requires use of premium fares. Because the contractor has not justified the use of the premium fares, we have questioned the \$2,700 difference in fares in accordance with FAR 31.205-46.

The contractor does not concur, claiming that the trips were by management officials for whom written approval was not required. The issue of allowability does not hinge on whether the first-class air fares were approved. Rather, the difference between first-class fares over lower-class fares is unallowable except when lower-class fares are not available and travel must take place. We recommend that a penalty be assessed on the questioned first class air travel in accordance with the provisions of DFARS 231.7002-1(a)(1).

7. Employment expense

The \$3,250 questioned represents the cost of three-color, full-page, help-wanted advertisements in weekly news magazines. Our audit showed these costs to be unallowable under FAR 31.205-34(b) because the advertising was excessive relative to the number and importance of the positions and included both material not relevant for recruitment purposes and color.

The contractor does not concur with \$2,250 of the \$3,250 we have questioned. The contractor claims that such advertising is necessary to attract sufficient qualified employees in today's highly competitive labor market, but has not provided tangible evidence in support of its position.

FAR 31.205-34(b) is specific in stating the elements which make recruitment advertising unallowable, and this advertising contained three elements which make the advertising unallowable. We questioned similar advertising costs in the contractor's most recent indirect cost settlement agreement (Audit Report No. _____, dated _____) at which time the contractor concurred. Accordingly, these costs were determined to be unallowable prior to the date of submission of this proposal. We therefore recommend that a penalty be assessed on the entire amount of questioned advertising expense in accordance with the provisions of DFARS 231.7002-1(a)(2).

8. Allocation base

The increase in the direct labor hours base consists of:

	Hours	Reference
	8,000	a.
	(2,150)	b.
Net Increase	<u>5,850</u>	

a. The addition of subsidiary TVV Corporation (TVV) direct labor hours that were not included in the allocation base by the contractor. We included these direct labor hours in the allocation base because TVV shares and uses the contractor's manufacturing facilities. Therefore, TVV should participate in the allocation of overhead. TVV paid the contractor only nominal rental for the use of its facilities, indirect personnel and equipment. Moreover, the rental income was not included as a credit to the factory overhead expense pool.

The contractor does not concur, claiming that TVV used the facilities only during infrequent shop overload conditions and then only to a limited degree. The contractor also claims that treatment of the rental charges as Other Income is proper under the circumstances.

Our audit disclosed that TVV's use of the contractor facilities occurred on a continuing and regular basis; therefore, including TVV's direct labor hours in the base is not only proper, but also eliminates the discussion of the proper rental amount and where in the accounting records it should be credited.

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Figure 10-5-2**

- b. The subtraction of the inspection labor hours reclassified as indirect (see note 1 above).

10-600 Section 6 — Reports on Postaward Audits of Cost or Pricing Data

10-601 Introduction

a. This section provides guidance for preparing and distributing reports on postaward audits of contractor cost or pricing data for compliance with 10 U.S.C. 2306a. Such reports embody the results of audits performed using the guidance in 14-100. Auditors sometimes refer to these audits as "defective pricing audits," "audits for possible defective pricing," etc. In audit reports, however, FAOs should use the terms employed in this section.

b. Throughout this section the term "contracting officer" includes their representatives. The term "contract" also applies to subcontracts except where this section specifically notes a distinction.

10-602 Nature and Timing of Reports

a. The cost or pricing data for each pricing action (prime contract, modification, subcontract, etc.) is subject to a separate defective pricing audit. Therefore, separately report apparent defective pricing found on each pricing action.

b. For subcontract reporting, it is usually easier for the prime contract auditor to apply the prime contractor's additives to recommended subcontract price adjustments. The prime contract auditor may also need to perform other audit actions at the prime contract level, such as those involving possible "offsets" or the issuance of appropriate disapprovals under flexibly priced contracts for recommended subcontract price adjustments. Therefore, issue subcontract audit reports to the prime contract auditor. (However, see 4-702.8 for comments on issuing subcontract audit reports when there is alleged subcontractor fraud in connection with the defective pricing audit.) This procedure usually results in earlier holding of an exit conference with the prime contractor. It also provides for earlier involvement by the prime contract auditor in eventual negotiation of recommended prime contract price adjustments.

c. Issue all audit reports promptly, whether or not apparent defective pricing is disclosed. Regional Audit Manager (RAM) review is required for all positive defective pricing reports prior to their issuance. In addition, RAM review of all rebuttals and response letters related to these reports is required.

10-603 Format and Content of Reports

a. The nature and extent of the detail reported depends on (1) whether or not the audit disclosed apparent defective pricing, (2) materiality of recommended price adjustments, (3) results of discussions with the contractor including those involving offsets, and (4) items of special interest to the contracting officer or other authorized requester.

b. Minimum data requirements stated in 10-606.1 apply even if the audit did not disclose defective pricing. Also, supply the information as stated in 10-605 regardless of audit findings.

10-603.1 General Format

a. Prepare the report using the basic guidance contained in 10-100 and 10-200 plus the supplemental information provided by this section.

b. The general arrangement of report contents follows.

Audit report cover, if applicable (see 10-205)

Cover sheet (see 10-206)

Letterhead sheet for page 1, starting with audit report number (see 10-203.1)

"Subject" element (see 10-603.2)

"To" element (see 10-604)

Narrative body of report (see 10-605)

Signature element (see 10-210)

List of enclosures, if applicable; or table of contents, if required (see 10-212)

Distribution list (see 10-211)

Exhibits and schedules, if applicable (see 10-606)

Appendixes, if applicable (see 10-607)

Attachments, if applicable (see 10-608)

10-603.2 "Subject" Element

Following the general format in 10-207, include the title of the report ("Report on Postaward Audit of Cost or Pricing Data"), the prime contract number, the subcontract identification, if applicable, and the contractor's name, city, and state.

10-603.3 Release of Subcontract Audit Report to the Higher-Tier Contractor

a. If a government audit discloses defective subcontractor cost or pricing data, FAR 15.804-7(f) provides for contracting officer release of information, upon request to prime contractors or appropriate subcontractors to the extent necessary to secure a prime contract price reduction. However, the contracting officer must be careful to protect confidential business information from improper disclosure in such situations.

b. One of the following release statements will be included on the cover sheet of subcontract defective pricing audit reports and on higher-tier contractor audit reports containing recommended subcontractor price adjustments. The statement will appear in the first paragraph of the cover sheet following the standard release statement in 10-206.2(a).

(1) If the subcontractor does not object to the release of the report, add the sentence shown at 10-206.3c(1).

(2) If the subcontractor objects to the release of company proprietary information which may be included in the audit report, the following statement will be included:

"However, [insert name of subcontractor] considers [identify the data which the subcontractor objects to releasing] to be trade secrets or confidential business information. Accordingly, the contracting officer should protect such information from improper disclosure in accordance with FAR 15.804-7(f)."

10-604 Addressing and Distributing Reports

The general policy for addressing audit reports is stated in 10-208. Paragraph 10-211 states the general policy for report distribution. For reports covered by this

section, include the on-site PLA (refer to 15-3S1) on the distribution list.

10-604.1 Addressing and Distributing Prime Contract Audit Reports

a. If the auditor performed the postaward audit of cost or pricing data in response to a specific government request, address the report to the requester with a copy to the plant representative/ACO and/or the PCO, as appropriate.

b. If DCAA initiated the audit, address the report to the PCO with an information copy to the plant representative/ACO, unless the plant representative/ACO has negotiation authority. In that event, address the report to the plant representative/ACO with a copy to the PCO. The contract will identify negotiation authority for orders issued under basic ordering agreements.

c. The prime contract auditor will incorporate positive subcontract audit report findings and make distribution of a combined report (see 10-604.2). When the prime contract auditor is unable to complete the prime contract audit and issue a combined report within 30 days of receiving a subcontract audit report with positive findings, he or she will, as an interim measure, issue and distribute an audit report which includes the subcontract findings and the prime contractor's add-ons. See 14-119.4b for the proper application of prime contractor add-ons.

d. If the prime contract is flexibly priced and the subcontract audit report recommends disallowance or nonrecognition of incurred costs (see 14-119.4), the prime auditor will immediately advise the PCO. Timely action (1) allows the PCO to notify the prime contractor that the increased costs may be disallowed or not recognized on the prime contract and (2) enables the prime contractor to exercise the price reduction clauses it should have in its contract with the subcontractor. Delays in reporting subcontractor defective pricing may prevent the prime contractor from obtaining a subcontract price reduction, thus precluding the prime's legitimate recovery of its costs.

e. Distribute one copy of each report with apparent defective pricing on Army contracts, certain Air Force contracts,

and contracts issued by any contracting activity of the Defense Logistics Agency as shown in supplement 10-6S1.

f. Furnish the appropriate NASA Regional Audit Office (15-1S1) one copy of any report regarding apparent defective pricing on NASA prime contracts.

10-604.2 Addressing and Distributing Subcontract and Intracompany Audit Reports

a. For a subcontract or intracompany audit that was performed in response to a request by a contracting officer or other authorized person or activity, address the report to the requester with a copy to the prime contract auditor.

b. For a subcontract or intracompany audit report on a DCAA-initiated audit, address the report to the prime contract auditor. Do not distribute copies of these reports outside DCAA, since the prime contract auditor will make distribution of the combined report, if appropriate. The prime contract auditor will distribute the combined report as provided in 10-604.1.

c. Follow procedures similar to the above when dealing with lower-tier subcontracts. The prime contract auditor is responsible for obtaining intermediate-tier subcontractor add-ons when there are positive findings below the first tier of subcontracts.

10-605 Narrative

The body of the report will contain the following captioned paragraphs as applicable. See 10-209 for paragraph format.

10-605.1 Purpose and Scope of Audit

a. The first portion of this section should identify the pricing action audited and the purpose of the audit. It should also include information about the contract such as contract type, incentive provisions, total value of the pricing action covered by the audit, items purchased, and other appropriate information. Opening statements for five common situations could read as follows:

Example 1 (Prime contract audit requested by contracting officer):

As requested by [requesting office] in
[memorandum/letter] [reference]

dated _____, we have audited contractor cost or pricing data related to initial pricing of the subject contract. The purpose of the audit was to test whether the price, including profit, negotiated in that pricing action was increased by a significant amount because the contractor furnished cost or pricing data that was not accurate, complete, and current as required by 10 U.S.C. 2306a. In its Certificate of Current Cost or Pricing Data dated _____, the contractor certified the data as of _____, the date of agreement on price. The contract, initially priced at \$ _____, is firm-fixed-price type and provides for production and delivery of _____.

The cost and pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the cost and pricing data based on our audit.

Example 2 (DCAA-initiated audit):

We have audited contractor cost or pricing data related to the pricing of Supplemental Agreement No. 4 to the subject contract, as part of our continuing program of evaluating contractor compliance with 10 U.S.C. 2306a and implementing regulations. The purpose of the audit was to test whether the price, including profit, negotiated in that pricing action was increased by a significant amount because the contractor furnished cost or pricing data that was not accurate, complete, and current as required by the cited statute. In its Certificate of Current Cost or Pricing Data dated _____, the contractor certified the data as of _____, the date of agreement on price. The fixed-price-incentive contract provides for development, test, and evaluation of _____. The net target price added to the contract by the pricing action was \$ _____.

The cost and pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the cost and pricing data based on our audit.

Example 3 (Subcontract or intracompany audit requested by contracting officer or is DCAA-initiated):

Modify Examples 1 and 2 by substituting "subcontract" or "intracompany order" for "contract" wherever applicable.

Example 4 (Cost-reimbursement type contract):

For cost-reimbursement type contracts, the statement on purpose of the audit should not refer to "the price, including profit." Instead, use the following wording:

The purpose of the audit was to test whether the estimated cost or fee negotiated in that pricing action, or any cost reimbursable under this contract, was increased . . .

Example 5 (Lack of Certificate of Current Cost or Pricing Data):

If the contractor did not execute a Certificate of Current Cost or Pricing Data in connection with the pricing action(s) being reported on, modify the appropriate sentence in Examples 1 and 2. It may state, for example:

In the absence of the contractor's Certificate of Current Cost or Pricing Data for this pricing action, we have treated [the date that price agreement was reached or the date the contract (or modification) was executed] as the effective date of the contractor's responsibility for the cost or pricing data submitted.

b. Next, include an appropriate scope of audit statement, modified for circumstances that significantly affected the audit scope. Tailor the scope statement to accurately reflect the extent of audit work performed, especially when we have not performed a full audit. (Note: the auditor's decision to use "desk evaluation" procedures is not a scope impairment.) Use the following scope statements, as appropriate:

Example 1 (Unqualified report):

The criteria used to evaluate the cost or pricing data included the public law contained in FAR Subpart 15.8 and [the advance agreements and other pertinent provisions of the

contract as referenced in Appendix _____]. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records evaluated are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records evaluated. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion.

Example 2 (Qualified report):

Precede the words "We conducted our audit" in the second sentence of Example 1 by the phrase "Except as discussed in paragraph 2."

Example 3 (Explanatory modification used when the auditor limited audit scope to that requested by the contracting officer and the audit conclusions are not qualified):

The criteria used . . . as referenced in Appendix _____ . To satisfy your specific request, we limited this current audit to the following aspects: _____ . Except for this limitation, we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records evaluated are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records evaluated. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion.

¶10-605.1a.

We may continue to audit other aspects of the subject contract and may issue a separate report on such other aspects.

10-605.2 Circumstances Affecting the Audit

a. Include the paragraph on circumstances affecting the audit only if the audit results must be qualified because the stated purpose and scope could not be accomplished. In such a case, both the "scope" statement and the "summary of audit results" paragraph must specifically refer to this paragraph. Do not refer to any unqualified audit conclusions and recommendations in this section. Properly explain them in the other portions of the report.

b. Clearly explain the nature and potential impact of each circumstance that prevents an unqualified conclusion, as well as any steps taken to overcome or mitigate the problem. If applicable, also explain any further action the auditor will take after issuing the report.

c. For situations involving more than one qualification, use subcaptions to highlight the specific circumstances requiring a report qualification. For example, the subcaptions might read "a. Contractor's Denial of Access to Records" and "b. Inadequate Contractor Cost Records."

10-605.3 Summary of Audit Results

a. The results of audit (qualified, if appropriate) should be summarized in the narrative portion of the report. If the audit does not result in a recommended price adjustment, use wording similar to Example 1. If the results of audit reflect a recommended price adjustment, the basis of that adjustment should be briefly explained following the opening statement (Example 2). Refer to applicable exhibits, schedules, and appendixes which contain the detailed audit results. On flexibly priced prime contracts, separately present findings in the prime audit report for (1) recommended price adjustments and (2) recommended disallowance or nonrecognition of incurred costs (14-119.4b). If the audit is qualified, make reference to paragraph 2 (circumstances affecting the audit).

Example 1 (Unqualified conclusion with no audit exceptions):

Our audit, summarized as follows, disclosed no evidence that the price [cost and fee for cost-type contracts] was increased because the contractor furnished cost or pricing data that was not current, accurate, and complete.

Audit baseline	\$ _____
Recommended price adjustment	None

Example 2 (Unqualified conclusion with audit exceptions):

Our audit disclosed that the cost or pricing data submitted by the contractor was not accurate, complete, and current as of the date of agreement on price. [Briefly discuss the major recommended price adjustments, including a reference to any CAS reports issued per 14-120.2] Exhibit A [and the enclosures referenced therein] presents the detailed conclusions and recommendations resulting from our audit, which are summarized as follows:

Audit baseline	\$ _____
Recommended price adjustment	\$ _____

Example 3 (Qualified conclusion with possible added exceptions):

Insert any needed qualifying wording at the beginning of the first sentence in Example 1 or the second sentence in Example 2. Refer specifically to the possible effects, not merely to the circumstances, that led to the qualification. If access was denied to historical cost records, Example 2 might include the following qualification:

Except for additional recommended price adjustments, if any, that might result from access to the historical cost records of previously manufactured items as discussed above, Exhibit A . . .

b. Paragraphs 10-606 and 14-123 list minimum data required for exhibits and schedules. Place the data here rather than in the exhibits and schedules if this will provide a useful presentation for the

report readers. However, auditors should use an Exhibit A for even the simplest situation, when it expedites the FAO's report production procedures. As discussed in 14-123, each audit report with a recommended price adjustment must specifically address the five points for establishing defective pricing in the explanatory notes (14-102b).

c. Clearly identify details on significant offsets alleged by the contractor. Do this in a fashion similar to that used for the explanatory notes to Exhibit A. If appropriate, auditors can merely make reference to them here and cover the details in a separate exhibit. If the contractor has not submitted appropriate offset certifications for contracts entered into on or after 15 February 1987 (14-118b), include in the report an additional statement that the contractor refused to provide a certification and, for this reason, we have not included the claimed offsets in our computation of the recommended price adjustment and do not express an opinion on the claimed offsets.

d. When postaward audits disclose overpayments resulting from defective pricing on (1) DoD contracts or modifications awarded after 7 November 1985 or (2) other government contracts or modifications awarded after 22 January 1991, include the following statement as part of this portion for prime contract audit reports (see 14-124):

The government sustained a loss in the form of interest on overpayment which resulted from the contractor's failure to comply with the Truth in Negotiations Act (10 U.S.C. 2306a). As provided by the statute (applicable to DoD contracts) and/or FAR 15.804-7(b)(7) (applicable to contracts of all government agencies), this interest amount is computed at the current rate prescribed by the Secretary of the Treasury under Section 6621 of the 1986 Internal Revenue Code, from the time of the overpayment to the date the government is repaid.

e. When postaward audits at subcontractors disclose overpayments resulting from defective pricing on subcontracts

meeting the conditions in d. above, the subcontract auditor should include in this portion of the report a statement that any recommendations on interest due as a result of government overpayments will be made by the prime contract auditor.

f. If the expected prime interest amount will likely be \$10,000 or more, add the following sentence to the above statement:

See Exhibit _____ for details the responsible procuring official will need for making the computation.

If the interest amount will likely be under \$10,000, provide exhibit information only if requested by the contracting officer. See 14-124 and Figure 14-1-1 for an explanation of the information to be included in the exhibit.

g. Use this paragraph to confirm that factual matters relating to any apparent defective cost or pricing data were coordinated with the procuring contracting officer (PCO) or the PCO's representative during the course of the audit. (Provide auditor's name and title and PCO's name and title.) In addition, include a statement that a copy of the draft report exhibits and explanatory notes describing the recommended price adjustments were provided to the PCO (provide PCO name and date) in order to ensure that a mutual understanding of the facts and issues was reached (CAM 14-122). Also see 10-209.3 for other elements required in this portion of the narrative.

10-605.4 Contractor's Reaction

State in this paragraph the name and title of the contractor's principal representatives with whom the auditor discussed the results of audit (see 10-209.3e and 4-304.3). Include the date that the draft exhibit and notes explaining the findings were provided to the contractor. Also include in this paragraph a summary of the contractor's reaction comments on the major recommended price adjustments. Note, however, that comments on offsets alleged by the contractor are part of an earlier portion of the report (see 10-605.3c). When appropriate, state that the report includes the contractor's complete written response as an attachment. In a

brief auditor rejoinder following the summary of the contractor's reaction, discuss the validity of the contractor's response.

10-605.5 Unsatisfactory Conditions and/or Other Audit Recommendations

a. Use this paragraph to report any unsatisfactory conditions or questionable practices concerning the contractor's operations and the contract under audit. If a previously issued estimating system survey report describes the condition that caused the defective pricing, refer to that report. If an estimating system survey report has not cited the condition, present the condition here along with the related recommendations. Whether or not to include a particular condition or practice in this paragraph depends on the seriousness of the matter and how often it has been reported in the past.

b. To promote consistency in resolving cases where the cited condition is systemic or other reports present the same condition, include the following statement:

In our opinion the condition resulting from submission of the inaccurate, incomplete, or noncurrent data identified in Exhibit _____, Note _____, is systemic. We have issued similar audit reports on other affected contracts. To assist in the timely and consistent resolution of the reported findings, a current list of these reports and the affected PCOs is included in Appendix _____.

c. When there is reasonable basis to suspect that the contractor knowingly submitted inaccurate, incomplete, or noncurrent cost or pricing data, issue a referral of suspected irregular conduct using DCAA Form 2000.0. Following the procedures in 4-702.5, transmit a copy of the form to the contracting officer only if the responsible investigative agency does not object (see DCAAI 7640.16). For DoD contracts or modifications awarded after 7 November 1985, include the following statement in the transmittal:

Notwithstanding any potential civil or criminal fraud violations, 10 U.S.C. 2306a, as amended by Section 952(a) of the 1987 Defense

Authorization Act, states that a contractor who knowingly submits inaccurate, incomplete, or noncurrent cost or pricing data must pay a penalty in an amount equal to the overpayment. In our opinion, there is a reasonable basis to conclude that [contractor name] made a knowing submission as contemplated under the statute and, therefore, is liable to the government for \$ [amount].

d. When a pattern of deficiencies or discrepancies suggests fraud, other unlawful activity, or the existence of unsatisfactory conditions, refer or report the matter using the guidance in 4-700 or 4-800.

10-605.6 Disposition of Audit Results

a. If the auditor recommends a price adjustment, inform the contracting officer that further advice and assistance to reach a settlement on the recommended adjustment can be obtained (1) from the office issuing the report (include the FAO telephone and fax numbers) or (2) through the on-site procurement liaison auditor (include the PLA's name, telephone number, and office location, as shown in 15-3S1).

b. For apparent defective pricing cases with positive findings, request that the auditor be provided the opportunity to review and comment on any data received after report issuance that pertains to report recommendations. Also request that the contracting office advise the audit office of the disposition of the audit recommendations (FAR 15.804-7(d)).

c. See 10-209.4 for other requirements related to this portion of the report narrative.

d. When there is no evidence of defective cost or pricing data, as a minimum offer to provide any assistance necessary. Also provide a point of contact and the FAO telephone and fax numbers.

10-606 Exhibits and Schedules

10-606.1 Exhibit A

a. Except when the auditor can conveniently present all data and explanations in the report body (see 10-605.3), use Exhibit A to summarize the audit base-

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¶10-606.1a.**

line and the results of the audit (see 14-116). Minimum data required are:

Audit baseline (see 14-116.2).

Recommended price adjustment (Enter the total recommended price adjustment or "none" if the amount is zero.)

b. Figure 10-6-1 illustrates an Exhibit A presentation.

10-606.2 Additional Exhibits and Schedules

a. Additional exhibits and/or schedules may be needed for effective presentation if there are significant recommended price adjustments. Adequately explain each price adjustment in the notes to the exhibits and schedules. Include the reason the item is defective by establishing that each of the five elements required for defective pricing have been met (see 14-102b). In addition, include the relevant date for each recommended price adjustment when appropriate.

b. When the particulars related to contractor alleged offsets are extensive, and the auditor cannot conveniently present them in the report body (see 10-605.3c), refer to them in the "Summary of Audit Results." Present the details in a separate exhibit.

c. All exhibits, schedules, and appendices should be properly cross-referenced.

10-607 Appendixes

Use an appendix only for required supplementary or supporting information, as explained in 10-214. The report body or an exhibit or schedule will refer to any appendix included as part of the report. The following subparagraphs provide a checklist of potential appendix requirements for a report on apparent defective pricing.

10-607.1 Chronology of Significant Events

Use this appendix to show the significant events concerning the postaward audit of cost or pricing data. Include important dates for significant items reported in the exhibit to provide a clearer presentation.

10-607.2 Advance Agreements and Special Contract Provisions

Use this appendix to describe any advance agreements and special contract provisions which influenced the auditor's decision to recommend or not recommend a price adjustment. If brief, include this information within the "scope" portion of the report (10-605.1b).

10-608 Attachments

If received, include as an attachment a copy of the contractor's written comments resulting from the exit conference (see 10-605.4).

Figure 10-6-1
Audit Report on Postaward Audit of Cost or Pricing Data

Audit Report No. _____

EXHIBIT A
Page 1 of XX

XYZ Corporation
Los Angeles, California
RECOMMENDED CONTRACT PRICE ADJUSTMENT
CONTRACT NO. _____ (FFP)

	Audit Baseline (Note 1)	Recommended Price Adjustment	Reference
Material	\$ 200,000	\$ 80,000	Note 2
Material Overhead	20,000	8,000	Note 3
Direct Labor	120,000	15,000	Note 4
Labor Overhead	240,000	30,000	Note 5
Other Direct Costs	<u>50,000</u>		Note 6
Subtotal	\$630,000	\$133,000	
G&A Expense	75,600	15,960	Note 7
Total Cost	<u>*\$705,600</u>	<u>\$148,960</u>	
Profit*	<u>70,560</u>	<u>14,896</u>	Note 8
Total Price	<u>\$776,160</u>		
Total Recommended Price Adjustment		<u>\$163,856</u>	

*For an FPI contract, use the descriptive titles Target Cost and Target Profit; for CPIF, use Target Cost and Target Fee, and for CPFF, use Estimated Cost and Fixed Fee.

Explanatory Notes

1. Audit Baseline

The audit baseline represents the last SF 1411 dated 15 February 19XX submitted by the contractor plus any additional cost or pricing data submitted before the price agreement date of 24 March 19XX. Refer to the Appendix for the chronology of significant events.

2. Material

The contractor certified this item as containing 4,000 electric alternators at \$50.00 per unit for a total of \$200,000. Support for the unit price was a quotation from A.C. Shock, Inc., which was the lower of two responsive quotations. Our audit revealed that on 15 March 19XX, which was nine days before agreement on price and six days before the negotiations, the contractor received a third quotation from the Jones Electric Supply Company to supply the alternators at \$30 each. The contractor subsequently issued a purchase order for the 4,000 electric alternators at \$30 each to Jones Electric on 17 March 19XX.

Our review of the government Price Negotiation Memorandum (PNM) and discussions with the contractor and procuring contracting officer found that the contractor did not disclose the Jones

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Figure 10-6-1

Electric quotation and purchase order to the government prior to the price agreement date. The Jones Electric quotation and purchase order are factual cost or pricing data which the contractor had in their current purchasing files and should have been provided to the government prior to the price agreement. The PNM and the procuring contracting officer in her 22 August 19XX memorandum stated that reliance was placed on the defective A.C. Shock, Inc. quotation in reaching agreement on price. As a result of the government reliance on the defective quotation, the price negotiated for material was increased by \$80,000. The recommended price adjustment is computed as follows:

A.C. Shock Quotation	\$ 50
Jones Electric Quotation	30
Difference	<u>\$ 20</u>
Required Units	4,000
Recommended Price Adjustment	<u>\$80,000</u>

As shown in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

3. Material Overhead

The proposed and negotiated material overhead rate was 10 percent. Our review of this rate did not disclose any defective cost or pricing data. The recommended price adjustment of \$8,000 results from applying the negotiated rate to the recommended material price adjustment (\$80,000 X 10% = \$8,000). As discussed in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

4. Direct Labor

The proposed direct labor costs were estimated by applying 10,000 manufacturing hours to the average direct labor rate of \$12 for the proposed period of performance (10,000 X \$12 = \$120,000). We did not find any defective cost or pricing data relating to the proposed labor hours. However, our audit did find that an error was made in computing the average direct rate resulting in an overstated proposed rate of \$1.50.

Our review of government PNM and discussions with the procuring contracting officer found that the government was not aware of the error and relied on the defective direct labor rate when agreement was made on price. The contractor made the error when developing the supporting schedules to calculate the average rate. These schedules were available in the contractor's current pricing files but were not provided to the government during negotiations. As a result of the government reliance on the defective direct labor rate, the price negotiated for direct labor was increased by \$15,000. The recommended price adjustment is computed as follows:

Proposed Average Labor Rate	\$ 12.00
Correct Average Labor Rate	<u>10.50</u>
Difference	1.50
Proposed Hours	<u>10,000</u>
Recommended Price Adjustment	<u>\$15,000</u>

As shown in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

5. Labor Overhead

The proposed and negotiated labor overhead rate was 200 percent. Our review of this rate did not disclose any defective cost or pricing data. The recommended price adjustment of \$30,000 results from applying the negotiated rate to the recommended direct labor price adjustment (\$15,000 X 200% = \$30,000). As shown in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

6. Other Direct Costs

Our review of the other direct costs did not disclose any defective cost or pricing data.

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Figure 10-6-1

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7. G&A Expense

The proposed and negotiated G&A expense rate was 12 percent. Our review of the rate did not disclose any defective cost or pricing data. The recommended price adjustment of \$15,960 results from applying the negotiated rate to the recommended G&A base price adjustment ($\$133,000 \times 12\% = \$15,960$). As shown in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

8. Profit

The negotiated profit rate was 10 percent. The recommended price adjustment of \$14,896 was computed by applying the negotiated rate to the recommended total cost price adjustment ($\$148,960 \times 10\% = \$14,896$). As shown in the attached contractor response letter, the contractor agrees with the recommended price adjustment.

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10-6S1

**10-6S1 Supplement — Distribution of Reports on Postaward Review for
Certain DoD Contracts**

Army

In those cases where the U.S. Army Missile Command (MICOM) is not the requesting office, distribute a copy of each report on apparent defective pricing on MICOM prime contracts to:

Commander, U.S. Army Missile
Command
ATTN: AMSMI-AC-MAR
Redstone Arsenal, AL 35898

Air Force Materiel Command (AFMC)

Distribute one additional copy of each report on apparent defective pricing on prime contracts issued by AFMC procurement offices, identified by AF or F station codes as listed below, to the related pricing function as follows:

Codes Procurement Office

33615 Aeronautical Systems Center
33657 Attn: Directorate of Pricing,
PKF
Wright-Patterson AFB OH
45433-6503
33600 Hqtrs 2750th Air Base Wing
(AFMC)
Attn: 2750 ABW/PMT
Wright-Patterson AFB OH
45433-6503
19628 Air Force Electronic Systems
Center (ESC)
Attn: PKF
104 Barksdale Street
Hanscom AFB, MA 01731-
1806
04701 Space and Missile Systems
Center
04693 Attn: SMC/PKOF
155 Discoverer Blvd, Suite
1213
Los Angeles AFB, CA 90245-
4692
08635 Munitions Systems Center
Attn: Pricing Office, PMF
Eglin AFB FL 32542-5000

34601 Oklahoma City Air Logistics
34608 Center
34650

Attn: Pricing Division
OC-ALC/PKF
3001 Staff Dr, Suite 2A184A
Tinker AFB, OK 73145-3015
42600 Ogden Air Logistics Center
42610 Attn: Pricing Division
42620 OO-ALC/PKF
42630 6028 Aspen Ave
42650 Hill AFB, UT 84056-5206
41608 San Antonio Air Logistics
Center

Attn: Contracts Committee
SA-ALC/PKC
143 Billy Mitchell Rd
Kelly AFB, TX 78241-6014
04606 Sacramento Air Logistics Cen-
ter

Attn: PKPF
3237 Peacekeeper Way, Suite
17
McClellan AFB, CA 95652-
1060
09603 Warner Robins Air Logistics
Center
Attn: PKP
235 Byron Street
Robins AFB GA 31098-1611

(Example: Contract F09603-C-82-0093
or AF 09(603)-001 would have been
issued by the Warner Robins Air Logis-
tics Center, AFLC, Code 09603.)

Defense Logistics Agency (DLA)

Distribute one additional copy of ap-
parent defective pricing reports for con-
tracting actions issued by the Defense
Supply Centers and other DLA contract-
ing offices only (not DCMAOs or
DPROs) to the following address:
HQ Defense Logistics Agency
Attn: DLA-PPR
Cameron Station
Alexandria, VA 22304-6100

10-700 Section 7 — Audit Reports on Termination Settlement Proposals

10-701 Introduction

a. This section provides guidance for preparing and distributing audit reports on contractors' termination settlement proposals. As used here, the term contractor includes subcontractor. Do not use the term offeror in audit reports related to termination settlements.

b. These reports furnish termination contracting officers (TCOs) information and audit recommendations to assist them in negotiating termination settlements with contractors. For reports covering a subcontractor's termination settlement proposal to a higher-tier contractor, the report cover sheet must contain a statement on the subcontractor's agreement or disagreement with the release of the report to the higher-tier contractor. Follow the guidance in 10-206.3 in preparing this cover sheet.

10-702 Format and Content of Reports

a. Prepare the report using the format given in 10-200. Address the report to the TCO assigned responsibility for settlement of the contract. Include all pertinent information needed by the TCO to negotiate an equitable settlement.

b. Use a short form report (Figure 10-7-1) for settlement proposals under \$250,000 unless separate exhibits and schedules are needed for proper presentation. Also use a short form report when the audit finds few, if any, questioned or unresolved items (see 10-218).

c. Except as stated in b. above, the report will consist of a narrative section, accompanying exhibits and schedules, and appendixes, assembled as follows:

Narrative (10-703)

1. Purpose and Scope of Audit (10-703.1)
2. Circumstances Affecting the Audit (10-703.2)
3. Summary of Audit Results (10-703.3)
4. Disposition of Audit Results (10-703.4)

5. Signature Authentication (10-210)

6. Distribution (10-704)

Table of Contents (10-212)

Exhibits and Schedules (10-705)

Appendixes (10-706)

1. Other Matters to be Reported
2. Comments on Profit (or Fee)
3. Assist Audit Reports
4. Government Technical Reports

10-703 Narrative

10-703.1 Purpose and Scope of Audit

a. This part of the narrative will refer to the audit request, state the settlement proposal amount and whether it was submitted on the inventory or total cost basis. Also give summary information on the contract item, amount, and the status of completion when terminated if needed to understand the audit results.

b. Mention any aspects of the proposal emphasized during the audit at the express request of the contracting officer (12-201.1d).

c. Develop an appropriate scope of audit statement similar to that shown in 10-304.1b. However, this statement will also include the applicable criteria of FAR Part 49. Place the scope statement as a separate paragraph after comments made about the purpose.

10-703.2 Circumstances Affecting the Audit

Identify any circumstances which adversely affect the audit, or its results, per 10-209.2. For example, if the auditor requested the government technical evaluation or inventory verification reports and these reports were not provided, this section of the audit report would include explanation on the affect on the audit scope and results of not receiving this information.

10-703.3 Summary of Audit Results

Follow the guidance in 10-209.3 and 10-304.3 when preparing this part of the report. However, modify the language to fit the circumstances of a termination settlement proposal. For example, add a

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reference to FAR Part 49 (contains the criteria for terminating contracts). If the terminated contract is CAS-covered, modify the reference to Public Law 91-379 as necessary to conform with the exceptions noted in 12-104. Generally, a reference to "the practices required by applicable Cost Accounting Standards" will suffice.

10-703.4 Disposition of Audit Results

Follow the guidance in 10-209.4 when preparing this part of the narrative. Specifically, offer to provide additional audit service which the TCO may require in advance of or during negotiation. Also indicate any subsequent or supplemental reports you expect to issue. Request a copy of the record of the negotiations.

10-704 Report Distribution

a. Send the original and one copy of each audit report on a prime contract termination settlement proposal to the TCO. Furnish a copy when applicable to the on-site procurement liaison audit office servicing the TCO (refer to 15-3S1).

b. Address assist audit reports on sub-contract settlement proposals (original and two copies) to the auditor who made the request. On receipt, the requesting auditor will furnish the two copies to the TCO. These copies are either for his or her use, or if appropriate, for redistribution to the prime contractor or higher-tier subcontractor.

c. Furnish additional copies of the audit report as requested by the TCO.

10-705 Exhibits and Schedules

a. Include in the report any exhibits and supporting schedules required for a clear and complete presentation of the audit results.

b. Furnish the TCO enough information so he or she can clearly understand the basis of the amount proposed, the scope of audit, and the audit recommendations for each cost element. Show the contractor's reaction to the audit recommendations, particularly for questioned costs.

c. Show the results of audit in exhibits and schedules using columns labeled "Questioned Costs" and "Unresolved Costs." Do not use the category "unsupported costs" and do not use a column for accepted costs. Where several items were improperly classified in the contractor's settlement proposal (e.g., an item proposed as "other cost" which is more properly an element of settlement expense), insert a reclassification column in Exhibit A.

d. Figure 10-7-2 illustrates a typical "Exhibit A" format. Use supporting schedules rather than lengthy and complex footnotes.

10-705.1 Questioned Costs

The criteria and guidance in 10-308.1 for questioned costs also applies to termination settlement proposal audits. Comments such as "not necessary or incident to contract performance" or "excessive to contract requirements" require further explanation to adequately support a questioned cost.

10-705.2 Unresolved Costs

CAM 10-308.3 states the criteria for this category. Due to the nature of termination actions, this category may include items on which the auditor cannot reach a definitive conclusion. This is because it may be some time before the contractor's net cost or liability is firmly established (see 12-313). Examples of these items are severance or dismissal pay and the cost of unexpired leases. FAR 49.109-2 requires the TCO to include an appropriate reservation in the settlement agreement for any items still unresolved at settlement.

10-706 Appendixes

Use appendixes to provide information and comments as described in the following paragraphs.

10-706.1 Other Matters to be Reported

Use this appendix to furnish information which cannot be conveniently shown in the exhibits and schedules.

10-706.2 Comments on Profit (or Fee)

Make comments on the contractor's proposed profit or fee using the guidance

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¶10-706.2

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in 12-307 for fixed-price contracts, or 12-403 for cost-type contracts. Use an exhibit or schedule to show lengthy presentations or computations; e.g., calculating an adjustment for loss contracts (see 12-308). Two areas are especially important when developing comments on profit or loss for terminated contracts. First, no profit is allowable if the contractor would have incurred a loss had the contract been completed. The other is termination claims are reduced by an amount equal to

the pro rata portion of any loss applicable had the contract been completed.

10-706.3 Assist Audit Reports

For this appendix, follow the guidance given in 10-214.

10-706.4 Incorporation of Government Technical Reports

Follow the guidance in 10-307.9 in preparing this appendix.

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Figure 10-7-1

Figure 10-7-1
Short Form Termination Audit Report (Total Cost Basis, CAS Covered Contract)

Audit Report No. _____

Date _____

SUBJECT: Audit Report on Termination
Settlement Proposal
FFP Contract NA1-101
ABC Company
Philadelphia, Pennsylvania

TO: Termination Contracting Officer
Defense Contract Management District, Mid-Atlantic
Philadelphia, Pennsylvania

1. Purpose and Scope of Audit

a. As requested by your 2 August 1987 letter (reference Case No. A-111), we have audited the subject termination settlement proposal. The contract was terminated for the convenience of the government with an effective termination date of 3 April 1987. This proposal for \$234,000 was submitted on a total cost basis.

b. The termination settlement proposal and related supporting data are the responsibility of the contractor. Our responsibility is to express an opinion on the termination settlement proposal based on our audit.

c. Except as discussed in Paragraph 2, we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the termination proposal is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the termination proposal. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall termination proposal presentation. The cost principles in FAR Part 31 and the DoD Supplement (DFARS), the cost or pricing data requirements contained in FAR Part 49, and the practices required by applicable Cost Accounting Standards were used as criteria in the audit of the termination settlement proposal. We believe that our audit provides a reasonable basis for our opinion.

2. Circumstances Affecting the Audit

We made our recommendations without benefit of the inventory verification report, which was not available as of the date of this report. Therefore, the audit report is qualified accordingly.

3. Summary of Audit Results

a. In our opinion, the contractor has submitted adequate cost or pricing data. The settlement proposal has been prepared in accordance with FAR Parts 31 and 49 and the practices required by the applicable Cost Accounting Standards. Therefore, we consider the settlement proposal to be acceptable for negotiating a fair and reasonable price. This statement should not be interpreted to mean that the data are necessarily accurate, complete and current in accordance with 10 U.S.C. 2306a, since a postaward review may disclose evidence not now discernible.

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Figure 10-7-1

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b. The contractor's settlement proposal and our recommendations are summarized below.

<u>Cost Elements</u>	<u>Contractor's Settlement Proposal</u>	<u>Results of Audit</u>	
		<u>Questioned Costs (Note 1)</u>	<u>Unresolved Costs (Note 2)</u>
Direct material	\$ 85,000	\$3,000	—
Direct labor	45,000	1,200	—
Factory overhead	67,500	1,800	—
Other costs	4,500	—	—
G&A expense	10,100	300	—
Subtotal	212,100	6,300	—
Profit	18,900	—	—
Settlement expense	1,500	—	—
Settlement with subcontractor	2,500	—	\$2,500
Gross proposed settlement	235,000	6,300	2,500
Disposal credits	1,000	—	1,000
Net proposed settlement	<u>\$234,000</u>	<u>\$6,300</u>	<u>\$1,500</u>

Explanatory Notes

(1) Questioned Costs

The total cost of fabricated parts (PN 461-7829, work order 4606) was diverted to commercial production but not credited to the contract or deducted in the settlement proposal. The contractor concurs.

Direct material charges	\$3,000
Direct labor charges	1,200
Factory overhead at 150% of D/L	1,800
G&A expense at 5% X \$6,000	300
Total Questioned Cost	<u>\$6,300</u>

(2) Unresolved Costs

(a) Settlement of the subcontractor XYZ Company proposal for \$2,500 was not concluded as of the date of this report. We do not plan to further report on this item unless specifically requested.

(b) Disposal credits in schedule G of the settlement proposal for \$1,000 represent the contractor's estimate of the salvage value of the applicable items. Responses to requests for bid recently sent out have not been received.

c. We discussed questions about the contractor's proposal with Mr. Bob Smith, Controller, to obtain a full understanding of each item. Mr. Smith concurred in the findings shown in this report.

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Figure 10-7-1**

d. The information contained in this report should not be used for any purpose other than that immediately intended without first consulting us.

4. Disposition of Audit Results

a. For accounting counsel or additional audit services which the contracting officer may require in advance of or during the negotiation of this proposal, please contact Jim Jones, Supervisory Auditor, at telephone number (555) 274-7314 or fax number (555) 274-7567.

b. Please furnish us a record of the negotiations (FAR 49.110) as promptly as possible. We also invite your comments and suggestions on this report and related audit support.

DEFENSE CONTRACT AUDIT AGENCY

Joe Doe, Branch Manager

Figure 10-7-2 (Ref. 10-706)
Audit Report on Termination Settlement Proposal
(Inventory Basis)

EXHIBIT A

Page 1 of —

XYZ Corporation
Philadelphia, Pennsylvania
STATEMENT OF CONTRACTOR'S TERMINATION SETTLEMENT PROPOSAL
AND RESULTS OF AUDIT
FIXED-PRICE CONTRACT NO. _____

Audit Report No. _____

	Contractor's Settlement Proposal	Results of Audit (Note 1)		Reference
		Questioned Costs	Unresolved Costs	
Metals	\$ 18,000	\$ 6,000	—	Note 2
Raw Materials - other than metals	64,000	9,000	—	Note 3
Purchased parts	86,000	—	—	Note 4
Finished components	56,000	—	—	Note 5
Work in process	97,000	2,000	—	Note 6
Die, jig, fixtures and special tools	12,000	3,000	—	Note 7
Other costs	5,000	—	\$2,000	Note 8
General and administrative expense	16,900	1,000	100	Note 9
Subtotal	354,900	21,000	2,100	
Profit	32,100	**	—	Appendix 2*
Settlement expenses	7,000	2,000	—	Note 10
Subtotal	394,000	23,000	2,100	
Settlements with subcontractors	28,000	—	6,000	Note 11
Acceptable finished product	18,000	1,000	—	Note 12
Gross proposed settlement	440,000	24,000	8,100	
Disposal and other credits	18,000	—	—	Note 13
Net proposed settlement	<u>\$422,000</u>	<u>\$24,000</u>	<u>\$8,100</u>	

* Comments on profit should be included in an appendix to the report (see 10-706.2).
** Only adjustments computed for "loss" contracts should be shown as questioned costs. Loss adjustments should include the contractor's proposed profit.

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Figure 10-7-2

Explanatory Notes

1. We made our recommendations without benefit of the inventory verification and technical evaluation reports, which were not available to us.

2. Metals

The questioned costs represent the cost of steel bars (Item 6 on Inventory Schedule A) which were diverted to commercial use after preparing the settlement proposal. The contractor concurs. We traced a statistical sample of all items on the schedule to the related purchase orders. No discrepancies in unit costs were noted.

3. Raw materials - other than metals

The questioned costs represent the cost of plastic sheets (Item 2) and bulk insulation material (Item 4). The contractor regularly stocks these items and they are reasonably usable within six months. As such, they are not proper termination inventory items. The contractor does not concur, stating it does not wish to increase inventory of these items due to possible market declines.

4. Purchased parts

We qualify our acceptance of 900 switches, No. 14B at \$5.00 each (\$4,500). The purchase order specified delivery dates which appear to unreasonably accelerate production schedules compared to related items. The contractor stated that early delivery dates were specified for this critical part to avoid possible production stoppages. We refer final disposition of this item to the TCO. You may want to ask for the assistance of technical personnel to determine whether procurement was unreasonably accelerated. We found no discrepancies in unit costs when tracing a statistical sample of the schedule items to related purchase orders.

5. Finished components

Subject to the TCO's determining completeness and allocability, we consider direct labor, direct material, and applied indirect expense of the finished components listed in schedule B as acceptable costs.

6. Work in process

We audited direct labor, direct material, and factory overhead costs included in the work-in-process costs submitted by the contractor (Schedule C). We consider them acceptable, except for the following:

a. Starting load costs were disproportionately assigned to terminated units. Details are shown below (the contractor does not concur):

	Per Contractor	Per Auditor
a. Total units to be produced	64	64
b. Total units produced to date of termination	32	32
c. Average experienced hourly labor rate	\$3.00	\$3.00
d. Projected labor hours for entire contract quantity	11,585	12,919
e. Labor costs incurred to date	\$23,778	\$23,778
f. Projected labor costs for terminated units	10,977	14,979
g. Total estimated labor cost to complete contract (line c x line d)	\$34,755	\$38,757
h. Normalized cost for 32 units produced (1/2 of line g)	\$17,378	\$19,378
i. Unrecovered starting load cost (line e - line h)	\$6,400	\$4,400

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Figure 10-7-2

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j. Unrecovered starting load cost per auditor	<u>4,400</u>
k. Amount questioned	<u>\$2,000</u>

The contractor could not support its labor cost projection on the terminated units (Line f). We developed our projection by applying an 80 percent unit curve to the incurred cost on the completed units. This is the same improvement rate used in the past by the contractor and the government on cost projections for similar work.

b. Reviewing labor distribution records and time tickets disclosed \$661 in direct factory labor charged on work order 3201 after receiving the termination notice. The labor consisted of operation 12, performed on Items 2, 4, and 6 of Schedule C. The contractor claims it was impossible to stop operation 12 immediately after receiving the termination notice. Therefore, we qualify our acceptance of the direct labor (\$661) plus factory overhead at 127% (\$839) and refer them to the TCO for final disposition.

7. Dies, jigs, fixtures, and special tools

The contractor assigned \$12,000 to the terminated portion of the contract. This amount represented one-half of the special tooling purchased for the contract to the termination date. We found that some tooling items had already been fully consumed on the completed portion (50 percent) of the contract. The government technical inspector estimates that if the contract had continued to completion, it would have taken \$6,000 in additional tooling purchases to replace consumed items; and total special tooling costs for the contract would have amounted to \$30,000. We therefore computed questioned costs as follows:

Amount proposed by contractor	\$12,000
Amount computed by auditor:	
Estimated amount of tooling required for total contract	\$30,000
Amount not yet purchased	<u>6,000</u>
Tooling purchased to date	24,000
Purchased tooling applicable to completed portion (1/2 of \$30,000)	<u>15,000</u>
Purchased tooling applicable to terminated portion	9,000
Amount Questioned	<u>\$3,000</u>

The contractor's representative, Mr. Thomas Brown, Vice President in charge of Finance, did not agree. Mr. Brown maintained that since one-half of the contract quantity was terminated, they should assign one-half of the tooling to the terminated portion. However, with help from the government technical inspector, we determined that most of the tooling on hand was essentially worn out and would have required replacement to complete the contract quantity.

8. Other costs

We audited other costs, as listed in Schedule B of the settlement proposal. We consider them to be acceptable except for \$2,000 in severance pay. The contractor's liability for this item was not firmly established as of the date of this report.

9. General and administrative expense

The contractor based its G&A rate on actual costs adjusted for unallowable costs and for costs charged directly as settlement expenses. We computed questioned and unresolved amounts using the 5 percent rate proposed by the contractor and considered acceptable by us.

10. Settlement expenses

We audited the contractor's expenses and verified the individual items of expense listed in schedule E of the proposal. Labor costs are considered reasonable. However, we believe the amount claimed for overhead on settlement labor is unreasonable, since the contractor applied the full 127 percent factory overhead rate. We have developed an acceptable 45 percent rate using only payroll

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Figure 10-7-2**

taxes, fringe benefits, occupancy, and immediate supervision. The difference in the rates applied to settlement labor results in questioned settlement expense of \$2,000. The contractor does not concur.

11. Settlements with subcontractors

The unresolved costs represent a requested but not yet completed assist audit on a subcontractor's termination settlement proposal. If the contractor's proposal has not been settled when the assist audit is received, we will issue a supplemental report incorporating the assist audit report. We anticipate receipt of the assist audit report about 15 July 19XX.

12. Acceptable finished product

The questioned costs represent a price adjustment for freight on finished units not shipped. The contractor did not deduct these costs from the contract price, although the contract price included shipment costs to destination. The contractor concurs.

13. Disposal and other credits

We qualify our acceptance of the contractor's offer of \$1,300 to retain specified metals inventory items costing \$5,000. The specified metals are not common items. Responses to requests for bids on these items have not been received. The contractor stated it based the offer on consuming the items in commercial production instead of less expensive material normally used. Disposal credits for \$16,700 accurately reflect the proceeds from sales of termination inventory items at prices approved by the plant clearance officer.

10-800 Section 8 — Audit Reports on Cost Accounting Standards Matters

10-801 Introduction

This section provides guidance for preparing and distributing audit reports related to Cost Accounting Standards (CAS). These reports furnish administrative contracting officers with information and audit recommendations to assist them in making CAS determinations.

10-802 Nature of Reports

There are five basic types of CAS related reports. They are (1) reports on the adequacy of initial disclosure statements, (2) reports on CAS compliance audits, (3) reports on CAS noncompliances, (4) reports concerning adequacy and compliance of disclosure statement revisions, and (5) reports on cost impact proposals. Except for reports on noncompliances and CAS compliance audits, CAS reports are usually prepared in response to an audit request received from the administrative contracting officer (ACO).

10-803 Format and Content of Reports

a. Address the reports to the cognizant ACO. They should contain sufficient information for the ACO to determine, as appropriate, (1) disclosure statement adequacy or inadequacy, (2) noncompliance of the disclosure statement with CAS or FAR, (3) CAS noncompliance during contract performance or proposal submission, and (4) any necessary contract price adjustments. The report formats included in this section are intended to reduce report writing effort and increase uniformity in report presentation among FAOs.

b. Assemble reports on CAS matters as follows:

1. SUBJECT (report title)
2. TO (addressee)
3. Purpose and Scope of Audit
4. Circumstances Affecting the Audit
5. Statement of Changes (disclosure statement revisions or changes in established practice only)

6. Background Information
7. Summary of Audit Results
8. Statement of Conditions and Recommendations
9. Cost Impact (disclosure statement revisions only)
10. Disposition of Audit Results
11. Signature Authentication per 10-210
12. Exhibits, Schedules, and Appendixes (as necessary)

The format and content for each of the five basic types of CAS related reports are discussed in the following paragraphs.

10-804 Audit Reports — Initial Adequacy of Disclosure Statement

These reports are intended to inform the administrative contracting officer whether the contractor's initial submission of its disclosure statement adequately describes the contractor's cost accounting system. As such, the title of this type of report should be "Audit Report on the Adequacy of Disclosure Statement."

10-804.1 Purpose and Scope of Audit

a. Include the following statement in this paragraph:

"The purpose of our audit was to evaluate whether the subject disclosure statement adequately describes the cost accounting practices which the contractor proposes to use in the performance of government contracts covered by 41 U.S.C. 422."

"The disclosure statement and related data are the responsibility of the contractor. Our responsibility is to express an opinion on the adequacy of the disclosure statement based on our audit."

b. Include the following scope statement in this paragraph:

"We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reason-

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¶10-804.1b.

able assurance about whether the disclosure statement is current, accurate, and complete. An audit includes examining, on a test basis, evidence supporting the adequacy of the disclosure statement. We believe that our audit provides a reasonable basis for our opinion."

10-804.2 Circumstances Affecting the Audit

Separately identify and describe any special circumstances or conditions adversely affecting the audit or its result.

10-804.3 Background Information

Provide any supplementary data on the contractor's operations necessary to permit a better understanding of the circumstances surrounding any reported condition and recommendation.

10-804.4 Summary of Audit Results

a. This section of the report presents an opinion regarding the adequacy of the disclosure statement. Examples of optional statements are provided below:

- (1) "In our opinion, the subject disclosure statement adequately describes the contractor's cost accounting practices."
- (2) "In our opinion, the subject disclosure statement, amended by pages dated , adequately describes the contractor's cost accounting practices."
- (3) "In our opinion, the subject disclosure statement does not adequately describe the contractor's cost accounting practices. Accordingly, we recommend the contractor be requested to submit a revised disclosure statement."

b. The section will also include the following report disclaimer:

"This audit was limited to evaluating the adequacy of accounting practice descriptions in the subject disclosure statement. Accordingly, we express no opinion on whether the disclosed practices are proper, approved, or agreed to for pricing proposals, accu-

mulating costs, or reporting contract performance data."

c. State the name and title of the contractor's designated representative with whom audit matters were discussed.

d. Include a cautionary note that information in the audit report should not be used for other purposes without first discussing its applicability with the auditor.

10-804.5 Statement of Conditions and Recommendations

When the disclosure statement is considered inadequate, use this paragraph to present the statement shown below:

"We identified the following deficiencies in the contractor's disclosure statement:"

Each deficiency should then be identified to the disclosure statement item number and explained sufficiently to permit a thorough understanding of the problem. The report should include a recommendation for corrective action and the contractor's comments about the condition and recommendation.

10-804.6 Disposition of Audit Results

a. Use this paragraph to provide the field audit office telephone and fax numbers and to offer audit assistance for clarifying reported inadequacies or implementing recommendations.

b. Include in this section a request for feedback. For example:

"As required by FAR 30.202-7(a), please furnish this office a copy of your determination regarding the adequacy of the subject disclosure statement. We also invite your comments and suggestions on this report and our related audit support."

10-805 Audit Reports — CAS Compliance Audits

Use this report format when no instances of noncompliances are found during CAS compliance audits. If noncompliances are found, follow noncompliance report format (see 10-806).

10-805.1 Purpose and Scope of Audit

a. Include the following purpose statement in this paragraph:

"The purpose of the audit was to determine if the contractor has complied with the requirements of CAS [number and title of standards]. The contractor is responsible for compliance with the requirements of this standard. Our responsibility is to express an opinion on compliance with those requirements based on our audit."

b. Include the following scope statement in this paragraph:

"We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the contractor's accounting practices comply with the requirements referred to above. An audit includes examining, on a test basis, evidence about the contractor's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion."

10-805.2 Circumstances Affecting the Audit

Separately identify and describe any special circumstances or conditions adversely affecting the audit or its result.

10-805.3 Summary of Audit Results

a. Include the following qualified opinion in this paragraph:

"Our audit procedures disclosed no instances of noncompliance with CAS [insert numbers]. However, instances of noncompliance not detected during this audit may be discovered during our continuous audit of the contractor's cost accounting practices during performance of contracts."

b. State the name and title of the contractor's designated representative with whom audit matters were discussed.

c. Include a cautionary note that information in the audit report should not be used for other purposes without first discussing its applicability with the auditor.

10-805.4 Disposition of Audit Results

This paragraph should provide the field audit office (FAO) telephone and fax numbers and offer any audit assistance deemed necessary by the contracting officer. Also include in this section a request for feedback on the report.

**10-806 Audit Reports —
Noncompliance with Disclosed or
Established Practices, CAS, or FAR**

These reports are intended to explain noncompliances disclosed either in the initial disclosure statement compliance audit or in contract performance or proposal evaluation.

10-806.1 Purpose and Scope of Audit

Examples of statements applicable to noncompliances found are provided below:

a. The following is an example of paragraphs to use when a noncompliance is found during an audit of the disclosure statement:

(1) "We audited the subject disclosure statement to evaluate whether the disclosed cost accounting practices comply with the CAS Board's rules, regulations, and standards, and FAR Part 31. The contractor is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit."

(2) "The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the contractor has complied with the requirements referred to above. An audit includes examining, on a test basis, evidence about the contractor's compliance with those require-

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¶10-806.1a.

ments. We believe that our audit provides a reasonable basis for our opinion."

b. The following is an example of paragraphs to use when noncompliance is found during contract performance (use (1) & (3) if noncompliance is found during CAS compliance audits, use (2) & (3) for noncompliance found during other audits):

(1) "Our continuous audit of the contractor's cost accounting practices during performance of contracts includes evaluating whether the contractor has complied with the CAS Board's rules, regulations, and standards, and FAR Part 31. The purpose of the audit was to determine if the contractor has complied with the requirements of CAS [number and title of standard]. The contractor is responsible for compliance with the requirements of this standard. Our responsibility is to express an opinion on compliance with those requirements based on our audit."

(2) "Our continuous audit of the contractor's cost accounting practices during performance of contracts includes evaluating whether the contractor has complied with the CAS Board's rules, regulations, and standards, and FAR Part 31. The contractor is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit."

(3) "The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the contractor's accounting practices comply with the requirements referred to above. An audit includes examining, on a test basis, evidence about the contractor's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion."

c. The following is an example of paragraphs to use when noncompliance is found during a proposal evaluation:

(1) "Our audit of the contractor's cost accounting practices during proposal evaluations includes evaluating whether the contractor has complied with the CAS Board's rules, regulations, and standards, and FAR Part 31. The contractor is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit."

(2) "The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the proposal complies with the requirements referred to above. An audit includes examining, on a test basis, evidence about the contractor's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion."

10-806.2 Circumstances Affecting the Audit

Separately identify and describe any special circumstances or conditions adversely affecting the audit or its result.

10-806.3 Background Information

Provide any supplementary data on the contractor's operations necessary for a better understanding of the circumstances surrounding any reported noncompliance and the auditor's recommendation(s). Such data should not duplicate information already submitted in earlier reports.

10-806.4 Summary of Audit Results

a. This paragraph presents a summary statement of the noncompliance(s) being reported. An example follows:

"In our opinion, the contractor is in noncompliance with CAS 401, CAS 412, and FAR 31.205-6(j)."

b. The paragraph will include the following report qualification:

"This report is limited to the cited instance(s) of noncompliance. Accordingly, we express no opinion on whether other practices are proper, approved, or agreed to for pricing proposals, accumulating costs, or reporting contractor performance data."

c. State the name and title of the contractor's designated representative with whom audit matters were discussed.

d. Include a cautionary note that information in the audit report should not be used for other purposes without first discussing its applicability with the auditor.

e. See 10-209.4 for other requirements related to this portion of the report narrative.

10-806.5 Statement of Conditions and Recommendations

a. The paragraph should begin with one of the following statements:

(1) "Our audit identified a disclosed (or established) contractor practice which we believe is in noncompliance with the cost accounting standards and/or FAR Part 31, as follows:", or

(2) "Our audit disclosed that the contractor's failure to comply with a cost accounting standard and/or failure to follow consistently a disclosed cost accounting practice, has resulted or may result in increased cost paid by the government. The areas of noncompliance and/or failure to follow disclosed practices are stated below:"

b. Separately list each noncompliance item, with the following information:

(1) A sufficient identification and description of the noncompliance to permit a thorough understanding of the situation. Cite the specific CAS or FAR provision violated.

(2) An explanation of the significance of the problem.

(3) A specific recommendation for corrective action with a statement about any acceptable alternative solutions proposed by the contractor.

(4) The contractor's reaction to the issue.

(5) Auditor comments on the contractor's reaction and/or response.

10-806.6 Disposition of Audit Results

a. This paragraph should provide the field audit office (FAO) telephone and fax numbers and offer audit assistance in clarifying reported noncompliance(s) or implementing recommendations. It should also include a cross-reference to the related report on disclosure statement adequacy, if applicable.

b. Include in this section a request for feedback on the report. For example:

"As required by FAR 30.602-2, please furnish us a copy of your determination regarding the reported noncompliance(s). We also invite your comments and suggestions on this report and our related audit support."

c. In cases where a DCAA Summary Sheet is required (see 15-605), include the following statement:

"We have attached to the original copy of this report a Contract Audit Follow-up Summary Sheet in accordance with reissued DoD Directive 7640.2 dated 12 February 1988."

10-807 Audit Report — Concurrent Adequacy and Compliance Audits of Revised Disclosure Statements

Use the report format described below for reporting on accounting practice changes where a disclosure statement revision was submitted, or where no disclosure statement is required. In the latter instance the proposed established accounting practice change should be referenced instead of references to disclosure statement revisions in 10-807.1a, 10-807.3a, 10-807.5a, and 10-807.7a.

10-807.1 Purpose and Scope of Audit

a. Examples of purpose statements are provided below (use 1 & 2 for audits

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requested by the contracting officer; use only 2 for self-initiated audits):

(1) "In response to your (date) request, Case No. _____, we audited the subject revised disclosure statement.

(2) "The purpose of our audit was to determine whether the revised disclosure statement adequately describes the cost accounting practices which the contractor proposes to use in performing government contracts covered by 41 U.S.C. 422. We also audited the revised practices to evaluate whether they comply with applicable Cost Accounting Standards and FAR Part 31.

"The contractor is responsible for the disclosure statement and compliance of the disclosed accounting practices with applicable Cost Accounting Standards and FAR Part 31. Our responsibility is to express an opinion on the adequacy of the disclosure statement and whether the disclosed accounting practices comply with those requirements based on our audit."

b. Insert the following paragraph in both contracting officer requested and self-initiated audits:

"We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the contractor has complied with the requirements referred to above. An audit includes examining, on a test basis, evidence about the contractor's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion."

10-807.2 Circumstances Affecting the Audit

Separately identify and describe any special circumstances or conditions adversely affecting the audit or its result.

10-807.3 Statement of Changes

a. Use this paragraph to state the change, along with the effective date of the change, on which the revision to the contractor's disclosure statement is based. For example, the paragraph may read:

"The subject disclosure statement revision reflects the following change to the contractor's accounting practices (or operations, organization, etc.), and is effective on (or on the dates noted below):"

b. The paragraph should also contain an appropriate reference to the procedures prescribed in the FAR clause for disclosure statement revisions. Examples of statements are provided below:

(1) "The change(s) results from implementing a new Cost Accounting Standard and is therefore subject to negotiation with the ACO for an equitable adjustment under FAR 52.230-2(a)(4)(i)."

(2) "The voluntary change(s) has not been agreed to by the contracting parties. Terms and conditions are therefore subject to negotiation with the ACO under FAR 52.230-2(a)(4)(ii)."

(3) "The change(s) agreed to by the contracting parties is subject to negotiation with the ACO for an equitable adjustment under FAR 52.230-2(a)(4)(iii)."

(4) "The change(s) results from the contractor's agreement with, and correction of, a previously determined noncompliant condition, and is, therefore, subject to government recovery of increased costs together with interest under FAR 52.230-2(a)(5)."

10-807.4 Background Information

Provide supplementary data on the contractor's operations as necessary for a better understanding of the circumstances surrounding any reported disclosure statement inadequacy or instance of noncompliance and the auditor's recom-

mendation. Such data should not duplicate information already submitted in earlier reports.

10-807.5 Summary of Audit Results

a. This paragraph presents an opinion on the adequacy and compliance of the disclosure statement revision. Examples of optional statements are provided below:

(1) "In our opinion, the subject revision adequately describes the contractor's revised cost accounting practices. We noted no instances of noncompliance with applicable Cost Accounting Standards or FAR Part 31."

(2) "Although we noted no instances of noncompliance with applicable Cost Accounting Standards or FAR Part 31, in our opinion the subject disclosure statement revision does not adequately describe the contractor's revised cost accounting practices. Accordingly, we recommend the contractor be requested to submit a revised disclosure statement."

(3) "In our opinion, the subject revision adequately describes the contractor's revised cost accounting practices. However, during our audit we identified certain of the contractor's disclosed practices which we believe are in noncompliance with [insert CAS number(s) and/or specific FAR Part 31 reference]. The details of the noncompliance(s) have been reported separately in audit report number [insert report number]."

(4) "In our opinion, the subject disclosure statement revision (amendment) does not adequately describe the contractor's revised cost accounting practices. Accordingly, we recommend the contractor be requested to submit a revised disclosure statement. Also, during our audit we identified certain of the contractor's revised practices which we believe are in noncompliance with [insert CAS number(s) and/or specific FAR Part 31 reference]. The details of the

noncompliance(s) have been reported separately in audit report number [insert report number]."

b. State the name and title of the contractor's designated representative with whom audit matters were discussed.

c. Include a cautionary note that information in the audit report should not be used for other purposes without first discussing its applicability with the auditor.

10-807.6 Statement of Conditions and Recommendations

a. This paragraph, applicable whenever inadequacies were found, should begin with the following statement.

"We identified the following inadequacies in the contractor's revised disclosure statement:"

b. List each inadequacy item separately with the type of information cited in 10-804.5.

10-807.7 Cost Impact

a. The paragraph should contain an estimate of the cost impact, if available, and a reminder to the ACO to obtain a cost impact statement. To do this, start this paragraph with the following statement:

"The contractor is responsible for submitting cost impact proposals and for engaging in negotiations of adjustments resulting from changes to disclosed accounting practices. A cost impact proposal should contain sufficient detail to permit evaluation and negotiation of the effect upon each contract and subcontract containing the CAS clause. It shall contain as a minimum the following information:

"(a) identification of all contracts and subcontracts containing the CAS clause; and"

"(b) the effect (including cost, profit/fee, price/amount) on each contract and subcontract from the effective date of the change until completion of the contract or subcontract."

"It is not practical to estimate the magnitude of the total cost impact for the change(s) in the revision prior to your obtaining this information from the contractor. However, in the way of a partial estimate. . . ." (Include an estimate of the cost impact or delete the last sentence if the auditor is unable to provide a partial estimate and instead explain why an estimate could not be provided.)

b. When there is increased cost to the government because of a discretionary change, which is subject to the provisions of FAR 52.230-2(a)(4)(ii), the following should be included:

"We estimate the increased cost to the government because of the change to be \$ _____. However, any agreement which would result in net increased cost to the government would be contrary to the provisions of FAR 52.230-2(a)(4)(ii)."

10-807.8 Disposition of Audit Results

a. Use this paragraph to provide the Field Audit Office (FAO) telephone and fax numbers and offer audit assistance for clarifying reported inadequacies or implementing recommendations. Also include in this section a request for feedback. For example:

"As required by FAR 30.202-7(a), please furnish this office a copy of your determination regarding the adequacy of the subject disclosure statement. We also invite your comments and suggestions on this report and our related audit support."

b. See 10-209.4 for other requirements related to this portion of the report narrative.

10-808 Audit Reports — Cost Impact Statements

This section describes the format for audit reports on evaluations of cost impact statements.

10-808.1 Purpose and Scope of Audit

a. This paragraph should reference the audit request, other related audit reports (e.g., noncompliance reports), and any other documents which contain pertinent information about the contractor's cost impact submission. The information contained in the referenced documents should not be duplicated in the cost impact evaluation report. Also reference the date of the contractor's cost impact statement and the effective date of the changed accounting practice which resulted in the cost increases or decreases. The changed accounting practice should be described and categorized as either a:

(1) Change resulting from the implementation of a new standard (equitable adjustment).

(2) Discretionary change which is not agreed to by the contracting parties (no increased costs to the government).

(3) Sanctioned change other than one resulting from the implementation of a new standard (equitable adjustment).

(4) Change resulting from the correction of a CAS noncompliance.

b. An example of an acceptable statement follows:

"As requested by your 30 September 19XX letter, we audited the XYZ Corporation 31 August 19XX cost impact proposal reflecting the contractor's discretionary accounting change to combine the engineering and logistics overhead pools, effective 1 November 19XX. Since the accounting change has not been agreed to by the ACO, it is subject to the provisions of FAR 52.230-2(a)(4)(ii).

"The cost impact proposal and related supporting data are the responsibility of the contractor. Our responsibility is to express an opinion on the cost impact proposal based on our audit."

c. Insert the following paragraph:

"We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and

perform the audit to obtain reasonable assurance about whether the cost impact proposal is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the cost impact proposal. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall cost impact proposal presentation. The requirements set forth in FAR 30.6 were used as criteria in evaluating the cost impact proposal. We believe that our audit provides a reasonable basis for our opinion."

d. Add any qualification as to the completeness and accuracy of the universe of CAS-covered contracts.

10-808.2 Circumstances Affecting the Audit

Separately identify and describe any special circumstances adversely affecting the audit or its result.

10-808.3 Background Information

Provide any supplementary data on the contractor's operations to improve understanding of the circumstances surrounding any reported condition or the auditor's recommendation.

10-808.4 Summary of Audit Results

a. Begin this paragraph with an opinion statement on the adequacy of the data submitted by the contractor. As an example, the report could read:

"Although not adequate in all respects (see comments in Exhibit A), in our opinion, the contractor has submitted data which are acceptable for negotiating the cost impact due to the discretionary change."

The paragraph should comment on whether increased costs to the government resulted and refer to the report exhibit for details. (See Figure 10-8-1.)

b. State the name and title of the contractor's designated representatives with whom audit matters were discussed.

c. Include a cautionary note that information in the audit report should not be

used for other purposes without first discussing its applicability with the auditor.

10-808.5 Disposition of Audit Results

a. This paragraph should be used to provide the field audit office telephone and fax numbers and offer audit assistance in implementing the recommendation. If appropriate, recommend that an auditor attend the negotiations and offer to make available the detailed computations contained in the audit working papers.

b. Include in this section a request for feedback on the report. For example:

"As required by FAR 30.602-1(c)(1)(ii), please furnish us a copy of the negotiation memorandum at the conclusion of negotiations. We also invite your comments and suggestions on this report and our related audit support."

10-808.6 Exhibits and Schedules

The report should contain exhibits and supporting schedules required for a clear and complete presentation of the audit results and recommendations on all items in the proposed cost impact statement. They should include as a minimum the following information:

a. A schedule of contracts by type, showing proposed impact on cost, profit/fee, and price/amount.

b. An audit recommendation on cost impact for each contract. If totals are shown, indicate that they are for general information only and do not represent a recommendation regarding offsets or profit/fee adjustments.

c. Separate schedules showing detail for cost impact computations.

d. Comments on profit and offsets but not specific recommendations.

e. Contractor comments.

10-809 Distribution of Reports

a. Furnish copies of CAS audit reports to non-DoD agencies as noted in 15-1S7.

b. Furnish the CAC/CHOA/GAC copies of all CAS audit reports as provided in 15-200.

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c. Furnish the region copies of CAS audit reports following the procedures established by the region.

Figure 10-8-1
STATEMENT OF CONTRACTOR'S PROPOSED CONTRACT PRICE ADJUSTMENT
FOR
(a) THE IMPLEMENTATION OF CAS ____
(b) A VOLUNTARY CHANGE IN DISCLOSED ACCOUNTING PRACTICE
(c) NONCOMPLIANCE WITH CAS ____
(d) NONCOMPLIANCE WITH DISCLOSED ACCOUNTING PRACTICE
(e) NONCOMPLIANCE WITH CAS ____ AND DISCLOSED ACCOUNTING PRACTICE
AND RESULTS OF AUDIT

<u>CONTRACT/SUBCONTRACT</u>	<u>CONTRACTOR'S PROPOSAL</u>			<u>RESULTS OF AUDIT</u>	
	<u>COST</u>	<u>FEE/PROFIT</u>	<u>PRICE/ AMOUNT</u>	<u>RECOM- MENDED COST</u>	<u>REFERENCE</u>
CPFF					
Net Increase (Decrease)	\$ ____	\$ ____	\$ ____	\$ ____	
CPIF					
Net Increase (Decrease)	\$ ____	\$ ____	\$ ____	\$ ____	
FFP					
Net Increase (Decrease)	\$ ____	\$ ____	\$ ____	\$ ____	
FPI					
Net Increase (Decrease)	\$ ____	\$ ____	\$ ____	\$ ____	
Total Net Increase (Decrease)	<u>\$ ____</u>	<u>\$ ____</u>	<u>\$ ____</u>	<u>\$ ____</u>	

- The report notes will be consistent with those used for all pricing proposal audit reports. Separate notes or schedules will show detail of cost impact computations.
- Include separate schedules (or exhibits) for price adjustments subject to cost or pricing data certification. In these instances, present data in same format as included on the SF1411 submission.
- Comments relating to profit and potential offsets may be made as an explanatory note or included in a report appendix. However, specific recommendations on profit and offsets should not be made.

10-900 Section 9 — Final Audit Reports on Cost-Reimbursement and Time and Material Type Contracts and Subcontracts**10-901 Introduction**

This section provides guidance for the processing of completion vouchers and preparation and distribution of contract audit closing statements on completed or terminated cost-reimbursement and time and material type contracts and subcontracts. Contract audit closing statements for non-DoD agencies and time and material type contracts are normally performed on a request basis (see also 15-103). Guidance on assist reports to other contract auditors is in 6-800. Further guidance concerning processing completion vouchers is in 6-1000.

10-902 Receipt of Completion Voucher

a. When a completion voucher and accompanying documents are received from a contractor, the auditor should verify that the completion voucher is marked as such and related closing documents are included. If the completion voucher or closing documents must be returned to the contractor because of incomplete documents, incorrect amounts, etc., a copy of the transmittal letter should be sent to the cognizant administrative contracting officer (ACO) or termination contracting officer (TCO).

b. If the completion voucher and accompanying documents are in order, the auditor should promptly submit advance copies to the ACO or TCO. A transmittal letter will be used to forward the following documents, if applicable. Any circumstances requiring contracting officer assistance (e.g., incentive fee based on performance) may be requested in the transmittal.

- (1) Contractor's Release of Claims.
- (2) Assignee's Release of Claim, if applicable.
- (3) Contractor's Assignment of Refunds, Rebates, Credits and Other Amounts, if applicable.
- (4) Assignee's Assignment of Refunds, Rebates, Credits and Other Amounts, if applicable.

c. The above procedures do not pertain to completion vouchers received with requests for audit.

10-903 Processing Completion Vouchers

a. The auditor's processing of a completion voucher for the issuance of a contract audit closing statement usually constitutes final audit action on the contract. Before this final audit action, the auditor should:

(1) Complete the audit of the contractor's operations and costs related to the contract.

(2) Reach a final audit determination on the allowability of all amounts claimed under the contract. Use cumulative allowable cost worksheets when available. Otherwise, identify allowable direct costs by year from annual audit files and apply the lesser of final indirect rates or contract ceiling rates to appropriate bases. For time and material contracts, determine the allowable hours incurred by direct labor category. Apply the contract rates to the hours incurred.

(3) Determine the amount of fixed or incentive fee payable under the terms of the contract. In cases where the contract provides for an incentive fee based in part upon performance or quality objectives, coordinate with the administrative contracting officer to obtain the information necessary to determine the contract fee.

(4) See 6-1008.2 for further actions that should be taken.

b. The auditor's signature will not be shown on the completion voucher. Only the contracting officer is authorized to sign the final voucher. The contract audit closing statement is used to express the auditor's opinion on the contract as a whole.

10-904 Contract Audit Closing Statements on Cost-Plus-Fixed-Fee Level-of-Effort Contracts

The term form of a cost-plus-fixed-fee contract, per FAR 16.306(d)(2), requires

the contractor to provide a specific level of effort within a definite period of time. The contract audit closing statement will state the level of effort expended by the contractor so the contracting officer may determine whether an adjustment should be made in the fixed fee payable under the contract.

10-905 Preparation of Contract Audit Closing Statements

a. The contract audit closing statement is usually the final audit report to be submitted upon completion or termination of a cost-reimbursement, or time and material type contract or subcontract. A contract audit closing statement normally will be submitted upon completion or termination of each task order under a task order type contract or each line item, sub-line item, or portion of a multiple funded contract for which separate funding is provided in the contract.

b. Some contracts have numerous task orders, sub-line items, or other separate portions that are separately funded. Listing cost data for separate tasks or line items of a contract in a single audit report is a more efficient way of presenting closing information. Therefore, with the agreement of the customer, issuing a contract audit closing statement with a listing of cost data by separate task orders or line items under the contract is an acceptable alternative to issuing a separate audit report for each task order or line item number. Such a consolidated report must provide all pertinent information for each task order or line item number being closed.

c. The contract audit closing statement shall include the auditor's opinion on the allowability of the costs claimed by the contractor and present comments on the contractor's operations which are pertinent to the final settlement of the contract.

d. The format of a contract audit closing statement is shown in Figure 10-9-1. The type of information shown in "circumstances affecting the audit" paragraphs 2c. through 2h. of Figure 10-9-1 should be included when significant and appropriate. Additional pertinent comments on other items should be added.

10-906 Quick Closeout Procedures

When requested by the contracting officer, in conjunction with contracts which have been identified for administrative closeout under FAR 42.708, the auditor should issue a contract audit closing statement for physically completed cost reimbursement or time and material type contracts where final payment has been requested by the contractor. (See 6-1009)

When preparing the closing statement in this situation, the report will clearly indicate what costs and fiscal periods have been audited and which have not been audited. Suggested wording and format are given in Figure 10-9-1.

10-907 Distribution of Contract Audit Closing Statements

a. Contract audit closing statement (original and three copies or original and two copies for AID contracts) shall be distributed as follows:

(1) Closing statements other than in (2) through (6) below will be submitted to the administrative contracting officer.

(2) Closing statements for terminated contracts (see 10-902) will be submitted to the termination contracting officer. The closing statement should be issued no later than the submission date of the advisory audit report on the contractor's termination settlement proposal.

(3) Closing statements related to NASA contracts will be sent to the cognizant contracting officer, with a copy to the NASA Office of Inspector General cognizant of the geographical area in which the contractor is located. (See Supplement 15-1S1.)

(4) For the Department of Health and Human Services (DHHS), closing statements will be submitted to the DHHS Inspector General office which requested the audit.

(5) Audit reports issued on AID contracts should be addressed to the Office of Regional Inspector General/Audit/Washington, Room 514 RPE, Agency for International Development, Washington, DC 20523 (see 13-704).

(6) Reports related to National Guard Bureau contracts will be issued to the

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United States Property & Fiscal Officer (USP&FO) designated as the contracting officer (14-903).

b. Where the completion voucher and related closing documents (original and

six copies) have not been previously submitted to the ACO/TCO, they should be forwarded as enclosures to the closing statement.

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Figure 10-9-1

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**Figure 10-9-1
REPORT FORMAT**

Audit Report No. _____

SUBJECT: Contract Audit Closing Statement

Contract No. _____
(Contractor) _____
(Location) _____

[For final audits of subcontracts, the following should be used:]

SUBJECT: Contract Audit Closing Statement

Subcontract No. _____
Under Prime Contract No. _____
Subcontractor to (Prime's Name) _____
(Subcontractor's Name) _____
(Subcontractor's Location) _____

TO: Administrative Contracting Officer
(Name and Address of the Military Department or Agency that
administers the Contract)

1. Purpose and Scope of Audit

a. We audited final voucher no. _____ under contract no. _____ (subcontract no. _____ issued under prime contract no. _____). The purpose of the audit was to determine the allowable cost (and fee) under the contract (subcontract).

a. We audited final voucher no. _____ under contract no. _____

[The following paragraph should be used when the auditor has received a request for audit.]

a. As requested by your letter dated _____, reference no. _____, we audited final voucher no. _____ under contract no. _____ (subcontract no. _____ issued under prime contract no. _____). The purpose of the audit was to determine the allowable cost (and fee) under the contract (subcontract).

b. This (CPFF, CPAF, CPIF, CS, CR, CPFF-LOE, FPI, T&M) contract (task or delivery order), provided for (provide a brief statement of the nature and scope of work). Work commenced _____ and was completed _____.

c. We have audited the contractor's accounting records and financial operating procedures for the purpose of determining whether the amounts claimed for reimbursement by the contractor, as represented by public vouchers submitted, constitute allowable costs under the terms of the contract. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion.

[If the contract audit closing statement is being issued to close out a contract under quick close out procedures (6-1009 and FAR 42.708), the "purpose and scope of audit" paragraph must be modified as shown below. The exception statement should state the period of time for which the indirect costs are unaudited.]

c. Except as noted below, we have audited the contractor's accounting records and financial operating procedures for the purpose of determining whether the amounts claimed for reimbursement by the contractor, as represented by public vouchers submitted, constitute allowable costs under the terms of the contract. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence

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Figure 10-9-1

supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion.

2. Circumstances Affecting the Audit (The following circumstances will be included in the audit report as required.)

a. A brief statement should be made of any deficiencies in the contractor's accounting procedures, with the auditor's recommendations for corrective actions. This is necessary only where the contractor has other continuing auditable contracts or is expected to be awarded such contracts in the near future.

b. When quick closeout procedures are being used, make a brief statement that the review was performed in response to the contracting officer's request for assistance in closing out the contract (subcontract) using administrative quick closeout procedures under FAR 42.708. This should be followed by statements on what fiscal years have been audited and which have not been audited.

c. Comments should be made regarding any unclaimed wages, unclaimed deposits, unrepresented checks, and potential credits and refunds.

d. Provide a brief statement of any unresolved General Accounting Office informal inquiries or any outstanding notices of exceptions referred to the auditor. If available audit information indicates that any unresolved informal inquiries are likely to result in notices of exception, this should be stated.

e. If government funds were advanced to finance the contractor's operations, a statement should be made of the unliquidated balance of the advance, after all adjustments and any unpaid interest charges on such funds or contractor's failure to replace funds expended for disapproved expenditures.

f. Provide a statement of status of any unsettled disapprovals, outstanding subcontract legal actions, open insurance claims, or other unresolved items of which the auditor has knowledge.

g. When the work contemplated by the contract has not been physically completed, the auditor should comment upon this situation so that the contracting officer may determine whether an adjustment should be made in the fixed fee payable under the contract.

h. When government furnished material or equipment is furnished to the contractor in amounts greater than contemplated by the terms of the contract, thereby relieving the contractor of the responsibility of furnishing the items, the matter should be commented on in order that the contracting officer may determine whether the contractor is entitled to the stipulated fee. Additionally, if the contract provides for cost-sharing or participation by the contractor in cost savings, the auditor should indicate that part of the cost savings resulting from this factor.

3. Summary of Audit Results

a. In our opinion, \$ _____ represents costs considered allowable under the contract (task/delivery order) and therefore reimbursable.

[The following summary paragraph should be used for a time and material type contract.]

a. In our opinion, \$ _____ is the total amount considered allowable under the contract (task/delivery order) and therefore reimbursable.

[The following will be used if the final voucher costs are in excess of the contract limitation.]

a. In our opinion, \$ _____ represents costs considered allowable under the contract (task/delivery order) and therefore reimbursable. However, the contractor's final voucher included costs in excess of contract limitations. We have determined that \$ _____ (insert amount of excess considered allowable or a statement that none of this excess is allowable) represents costs which are otherwise allowable but are in excess of contract limitations.

[The following will be used if quick closeout procedures are being applied.]

a. In our opinion, \$ _____ represents audited costs considered allowable through (insert last fiscal year reviewed) under the contract (task/delivery order) and therefore reimbursable. The claimed direct costs of \$ _____ and indirect costs of \$ _____ for (insert period) have not been audited by us and are subject to your negotiation.

As you requested, we are providing indirect cost rates for your consideration in settling the unaudited indirect costs. Our recommended rates are based on (billing rates, prior year's settlement of indirect rates, most recent year's certified final rate submission, FPRA, etc.). Details regarding these recommended rates are provided in (exhibit, schedule, note). Unaudited

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Figure 10-9-1

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direct costs have been verified to the contractor's summary records maintained for accumulating costs under this contract.

[Additional Summary of Audit Results paragraphs may be needed. Some examples of these paragraphs follow.]

b. In cases where the ACO has sustained, in whole or in part, any appeals by the contractor from amounts disapproved by the auditor, the report should so indicate. For example:

This amount includes \$ _____ which was initially disapproved by the auditor. Upon appeal by the contractor, the ACO subsequently determined these costs to be allowable.

The amount of contractor's claim disapproved under the contract is \$ _____ (exclusive of \$ _____ initially disapproved but subsequently determined allowable by the contracting officer).

c. If the actual allowable cost of contract performance is substantially below the contract estimated cost on which the fixed fee was based, the reasons for the underrun should be stated. Possible reasons may be an unrealistic initial cost estimate or the subsequent discovery of scientific phenomena by the government or others which reduced the effort required by the contractor to perform the contract. This will provide the contracting officer with information to determine whether the fixed fee stated in the contract is equitable.

d. When the completion vouchers are submitted directly to the ACO, the report should so state. For example, "The contractor has submitted Completion Voucher No. _____ and related closing documents directly to your office; therefore, they are not attached to this report."

e. Additional comments may be required to show how the allowable costs under a cost-sharing contract were determined.

f. The total fixed-fee (or incentive fee) payable to the contractor as determined under the (fee adjustment) provision of the contract is \$ _____.

g. Contract audit closing statements on level of effort contracts will include the following comments regarding direct labor hours worked.

The contract provision requires that _____ direct hours be incurred in the performance of contract requirements. The actual direct hours incurred are _____. The fee (does not require/requires) adjustment. (If the fee requires adjustment, the audit report should provide sufficient data to allow the administrative contracting officer to determine the allowable fee.)

h. The information contained in this report pertains to the subject contract (subcontract) and should not be used for other purposes without first consulting us.

4. Disposition of Audit Results

a. Any questions concerning this report may be directed to (insert name and title of individual to be contacted) at telephone number _____ or fax number _____.

b. Please provide any comments or suggestions you may have on this report and on the related audit support.

DEFENSE CONTRACT AUDIT AGENCY
(signed) John T. Smith
(typed) John T. Smith, Branch Manager*

Enclosures:

1. Final Voucher No.
2. Related Closing Documents (as applicable)
3. (Contractor)

*The title should be revised as appropriate to reflect the position of the individual signing the report.

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10-1000 Section 10 — Reserved

DCAA Contract Audit Manual

10-1100 Section 11 — Audit Reports on Claims

10-1101 Introduction

a. This section provides guidance for preparing reports on equitable adjustment submissions (proposals and claims) to be resolved using the Contract Disputes Act of 1978 (41 U.S.C. 601).

b. A claim is a written demand submitted under the disputes clause of the contract (FAR 52.233-1). Requested relief may include the payment of money, adjustment or interpretation of contract terms, or other relief. The standard changes clause (FAR 52.243) provides for a contract price adjustment because of a government-caused delay.

10-1102 Proper Terms for Reports on Claims

a. For initial claims submitted to the contracting officer, incorporate in the resulting audit report the terms "negotiation" and "Truth in Negotiations Act" as if the claim were a price proposal (a pricing action). A denied claim appealed to the ASBCA, the U.S. Court of Appeal for the Federal Circuit, or the U.S. Claims Court is no longer considered a pricing action. The appropriate terms cited in these cases are "adjudication" or "settlement" versus "negotiation."

b. Some pro forma comments used in price proposal reports are not suitable for claim reports. When the audit concerns a claim being appealed to the ASBCA or courts, do not refer to pricing terms that apply to expected negotiations. In particular, question costs for lack of support rather than classifying them as unsupported, because claim reviews deal with after-the-fact costs. Also, do not refer to 10 U.S.C. 2306a on claims required to be certified by the Contract Disputes Act of 1978 (use 41 U.S.C. 601).

10-1103 Content and Format of Reports

a. Since claims often involve legal issues and frequently are complex, the audit report must be sufficiently clear,

complete, and accurate to withstand the rigors of the appeal process.

b. The nature and extent of detail in the report depends on (1) the complexity of the claim, (2) the significance of errors or omissions, (3) the materiality of the auditor's recommended adjustments, (4) results of discussions with the contractor, and (5) the contracting officer's specific requests.

c. The minimum data requirements stated in 10-1105.1 apply, even if the review did not result in questions regarding the contractor's claimed costs or other qualitative or quantitative aspects. Also include in the report the information stated in 10-1104, regardless of the audit findings.

10-1103.1 General Format

Prepare the report following the guidance in 10-100 and 10-200, as supplemented by this section. The general arrangement of report contents follows:

Audit report cover, if applicable (10-205).

Cover sheet (10-206).

Letterhead sheet for page 1, starting with audit report number (10-203.1).

"Subject" element (10-207).

"To" element (10-208).

"Thru" element (10-208.4).

Narrative (10-1104).

Signature block (10-210).

Distribution list (10-211).

Table of contents, if applicable (10-212).

Exhibits and schedules, if applicable (10-1105).

Appendixes, if applicable (10-1106).

Attachments, if applicable (10-1107).

Following the general format in 10-207, include the title "Report on Equitable Adjustment Proposal" or "Report on Equitable Adjustment Claim." Also include the prime contract number; the subject identification, if applicable; and the contractor's name, city, and state.

10-1103.2 Addressing and Distributing Reports

The general policy for addressing audit reports is stated in 10-208; for report

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distribution, in 10-211. For all reports covered by this section, include the on-site PLA (refer to 15-3S1) in the distribution.

10-1104 Narrative

The body of the report will contain the following paragraphs, as applicable. (See 10-209 for paragraph format.)

10-1104.1 Purpose and Scope of Audit

a. The first paragraph under this heading should identify the type of submission reviewed and purpose of the audit. It should state the contract type, incentive provisions, total value of the submission, and whether the submission represents an equitable adjustment proposal or a claim under the Contract Disputes Act of 1978. Also include a statement that the submission is the responsibility of the contractor and that the auditor's responsibility is to express an opinion based on the audit (see 10-209.1b (1)). Add other appropriate information as necessary.

b. Include the following scope of audit statement as a separate paragraph, modified as shown where appropriate:

"We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the equitable adjustment proposal (claim) is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the equitable adjustment proposal (claim). An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall equitable adjustment proposal (claim) presentation. The cost principles in FAR, Subpart (insert applicable number) and the practices required by Cost Accounting Standards (omit on proposals or claims applicable to non-CAS-covered contracts) were used as criteria in evaluating proposed (claimed) costs. We believe that our audit

provides a reasonable basis for our opinion."

10-1104.2 Circumstances Affecting the Audit

a. Include this section only if qualifying the audit conclusions due to limitations related to the stated purpose and scope of review. In such a case, both the "scope" statement and the "summary of audit results" must specifically refer to this section. (Properly explain any unqualified audit conclusions and recommendations in other portions of the report. Do not refer to them in this part of the report.)

b. This section must clearly explain the nature and potential impact of each circumstance that prevents an unqualified conclusion, and any steps taken to overcome or mitigate the problem. If applicable, also explain any further action that the auditor will take after issuing the report.

c. For situations involving several circumstances, use separately captioned subparagraphs for each circumstance. For example, the subheadings might read:

"a. Contractor's Denial of Access to Records"

"b. Inadequate Contractor Cost Records"

d. Try to segregate issues requiring a qualified report. If limitations affect only portions of the review, issue an unqualified opinion on those areas unaffected by the limitation. Follow appropriate procedures such as those in 1-504, "Access to Contractor Records," or 1-505, "Records Destroyed or Not in Condition for Audit," for areas affected by the limitation.

e. If the nature of the audit scope limitation makes it impractical to segment the review, issue a qualified report. (For example, a denial of access affecting most or all cost areas or inadequate cost records usually cannot be segmented.) However, the auditor will continue trying to resolve the limitation, following the procedures outlined in 1-504 or 1-505.

10-1104.3 Summary of Audit Results

a. This section should summarize the audit conclusions (qualified, if appropri-

¶10-1104.3a.

ate) and refer to applicable exhibits, schedules, and appendixes.

b. Reporting standards (see Chapter 2) require an opinion on the adequacy of submitted cost or pricing data and their compliance with FAR and Cost Accounting Standards where such regulations and standards apply. If the contractor or the subject contract is exempt from CAS for any of the reasons identified in 48 CFR 9903.201-1, state this fact in the report. For example:

Contract number is not covered by Cost Accounting Standards Board rules and regulations because it is a sealed bid contract and is therefore exempt from all CAS requirements under 48 CFR 9903.201-1(b)(1).

c. Claims or proposals that include significant unsupported and/or questioned costs may warrant an adverse audit opinion (see 10-304.3c(10)). Express an adverse opinion when the contractor should take some specific corrective action before the government can consider the claim or proposal and related material as an adequate basis for adjudication, settlement or negotiation of a price adjustment (see 9-209.3).

10-1104.4 Unsatisfactory Conditions or Other Audit Recommendations

Use this section to report any unsatisfactory conditions or questionable practices relating to the contractor's operations and the contract under review. Whether the auditor should include a particular condition or practice in this section depends on its significance and the frequency of previous reportings. When the audit of a contractor's or subcontractor's records or information from other sources suggest fraud, other criminal activity, or the existence of unsatisfactory conditions, send a referral as provided by 4-700 or 4-800 (whichever is more appropriate in the circumstances).

10-1104.5 Contractor's Reaction

State in this section the name and the title of the contractor's representative with whom the auditor discussed factual matters (see 4-304.3). Summarize the

representative's formal comments (if any) and reference any contractor written response. Include the complete written response as an attachment. Put any rebuttals in a brief "Auditor's Comments" section.

10-1104.6 Disposition of Audit Results

a. If the auditor recommends a cost adjustment, inform the contracting officer that further advice and assistance to reach an agreement on the recommended adjustment can be obtained by (1) telephoning or submitting a request to the office issuing the report, or, when applicable, by (2) contacting the on-site procurement liaison auditor (include the PLA's name, telephone number, and office location as shown in 15-3S1). Include in this section the FAO's telephone and FAX numbers and a request that the contracting officer advise the audit office of the disposition of the audit recommendations.

b. See 10-209.4 for other requirements related to this portion of the report narrative.

10-1105 Exhibits and Schedules**10-1105.1 Exhibit (See Figure 10-11-1)**

If the auditor cannot conveniently present all data and explanations in the report body (see 10-1104), use an exhibit to summarize the proposal or claim along with the results of the audit. Include sufficient narrative information to give the reader a comprehensive understanding of the basis of the proposal or claim and, if applicable, the reasons for the auditor's use of a different method to determine an equitable adjustment.

10-1105.2 Additional Exhibits and Schedules

When using exhibits, include all required explanations in a single exhibit if the audit results are brief and straightforward. In most cases the auditor will need additional exhibits and/or schedules to effectively present significant recommended cost adjustments. Adequately explain each questioned element of cost in the notes to the exhibits and schedules. Present important dates in an appendix

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10-1105.2**

titled "Chronology of Significant Events" (10-1106.1).

10-1106 Appendixes

Use an appendix only for required supplementary or supporting information, as explained in 10-214. The report body, exhibit, or schedule should refer to any appendix included as part of the report. The following subparagraphs are a checklist of potential appendix requirements for a report on an equitable adjustment proposal or claim.

10-1106.1 Chronology of Significant Events (See Figure 10-11-1c)

a. This appendix lists the significant events leading up to or having a bearing on the proposal or claim. Its purpose is to ensure that the report's recipient and potential users (such as the ASBCA judge and attorneys) have an understanding of the key issues and events.

b. The chronology should show whether the contractor certified the submission

under the Contract Disputes Act or other regulatory provision, the certification date, whether the contracting officer has made a decision on entitlement, the date and amount of the initial price proposal, the basic contract plus modification amounts, key events regarding contract performance issues, the dates of alleged delays or disruptions, performance dates anticipated at award date, and actual performance dates.

10-1106.2 Advance Agreements and Special Contract Provisions

Use this appendix when information regarding advance agreements and special contract provisions having a bearing on the proposal or claim is too detailed to include within the "scope" portion of the report (10-1104.1).

10-1107 Attachments

Include as an attachment a copy of the contractor's written comments submitted in response to the exit conference (see 10-1104.5).

Figure 10-11-1a (Ref 10-1105)
Evaluation of Proposal for Equitable Adjustment

Audit Report No. _____

EXHIBIT A
Page 1 of 4

XYZ Company
Boston, Massachusetts
STATEMENT OF CONTRACTOR'S PROPOSAL FOR EQUITABLE ADJUSTMENT AND
RESULTS OF AUDIT
CONTRACT NO. _____

Cost Element	Contractor Proposal	Results of Audit	
		Questioned Costs	Reference
Subcontract	\$ 102,100	\$ 102,100	Note 1
Material Storage	14,000	14,000	Note 2
Loading and Unloading	6,000	6,000	Note 3
Transportation	3,000	3,000	Note 3
Inflation	13,500	13,500	Note 4
Labor	3,200	3,080	Note 5
Job Site Overhead	60,000	19,434	Note 6
Subtotal	\$ 201,800	\$ 161,114	
Profit	21,860	21,860	Note 7
Subtotal	\$ 223,660	\$ 182,974	
Bond	2,405	1,830	Note 8
Total Claim	<u>\$ 226,065</u>	<u>\$ 184,804</u>	

Explanatory Notes

1. Subcontracts

The contractor was unable to document the proposed costs claimed as being owed to a painting subcontractor. Our audit disclosed that the subcontractor's invoices were submitted and paid before the delay period.

2. Material Storage

The proposed cost is an undocumented estimate. Since the contractor's overhead expense pool includes warehouse cost, and there were no instances of warehousing shortage during the alleged delay period, the contractor suffered no loss in this cost element.

3. Loading, Unloading, and Transportation

The proposed costs are undocumented estimates. Since yard personnel handled the material and transported it in company trucks, the contractor charged these costs to the materials overhead pool. The contractor handled these materials only twice (the normal number of times) — once when stored at the contractor's warehouse and once when released to the work site. This would have occurred whether or not the delay happened.

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Figure 10-11-1a

4. Inflation

The labor rates incurred during the actual performance period on the subject contract did not increase. There is no evidence that any cost element increased during the period. Further, the contractor has not proposed any material and other direct costs price increase caused by the alleged delay.

5. Labor

The proposed labor costs and the results of our audit follow.

	<u>Proposed</u>	<u>Questioned</u>	
Superintendent	\$ 2,000	\$ 2,000	(a)
Maintenance Mechanic	<u>1,200</u>	<u>1,080</u>	(b)
	<u>\$ 3,200</u>	<u>\$ 3,080</u>	

(a) The superintendent did other duties during the alleged delay period. The contractor has not substantiated or even alleged that the superintendent's efforts were not productive. On the contrary, the superintendent charged other contracts during this period.

(b) Our analysis of maintenance records indicates that about four hours of mechanic labor per week incurred to provide preventive maintenance on the equipment used on the subject contract. Subject to a decision that the government actually caused the delay, we developed the following as the maximum allowable mechanic labor cost due to the alleged delay.

Proposed Cost \$ 1,200

Acceptable Cost:

$\$1,200/4 \text{ weeks} = \$ 300 \text{ per week}$
 $\$300/40 \text{ hours} = \$ 7.50 \text{ per hour}$
 $\$7.50 \times 4 \text{ hours} = \$ 30.00 \text{ per week}$
 $\$30.00 \times 4 \text{ weeks alleged delay}$

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Questioned Cost

\$ 1,080

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Figure 10-11-1a

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6. Job Site Overhead

The contractor calculated its claim for unabsorbed overhead using a variation of the Eichleay formula. In making its calculation, the contractor did not exclude unallowable and unallocable costs from the expense pool. We consider the following overhead expenses unallowable and related to the delay, assuming the alleged delay and the government's responsibility are established.

	<u>Contractor's Proposal</u>	<u>Results of Audit</u>	<u>Questioned Costs</u>
Contract Billings (a)	\$ 5,000,000	\$ 5,000,000	
Total Billings for Contract Period (b)	\$25,000,000	\$25,000,000	
Ratio (a)/(b)=(c)	20%	20%	
Total Overhead for Contract Period (d) (Schedule A-1)	\$ 5,475,000	\$ 3,701,650	
Overhead Allocable to the Contract (c)×(d)=(e)	\$ 1,095,000	\$ 740,330	
Performance Days (f)	365	365	
Daily Overhead (e)/(f)=(g)	\$ 3000.00	\$ 2028.30	
Delay Days (h)	20	20	
Amount Recoverable (h)×(g)	<u>\$ 60,000</u>	<u>\$ 40,566</u>	<u>\$ 19,434</u>

7. Profit

The purpose of an equitable adjustment under a delay claim is to pay contractors for additional costs incurred as the result of a delay caused by the government. FAR 52.212-15 specifically excludes profit from consideration.

8. Bond

Bond expense is a normal cost of a construction contract. We do not take exception to the claimed bond rate, but we have questioned the portion applicable to questioned base costs and profit (\$182,974 × 1% = \$1,830).

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Figure 10-11-1b

Figure 10-11-1b
Evaluation of Proposal for Equitable Adjustment

Audit Report No. ____

SCHEDULE A-1
Page 1 of 1

XYZ Company
Boston, Massachusetts
SCHEDULE OF INDIRECT COSTS
PROPOSED AND RESULTS OF AUDIT

<u>Element</u>	<u>Contractor Proposed</u>	<u>Questioned</u>	<u>Reference</u>
Auto & Truck Expense	\$ 26,724	\$ 10,000	Note 1
Advertising	6,724	6,724	Note 2
Employee Bonuses	10,500	10,500	Note 1
Office Supplies	8,019	1,000	Note 1
Contributions	10,000	10,000	Note 2
Entertainment	6,500	6,500	Note 2
Estimating Cost	4,674	1,000	Note 1
Repairs & Maintenance	19,068	500	Note 1
Payroll Taxes	83,830	83,830	Note 1
Telephone	17,703	6,969	Note 1
Officer Life Insurance	1,180	1,180	Note 2
Travel	11,033	1,777	Note 1
Depreciation	725,000	23,000	Note 1
Equipment Insurance	62,500	4,300	Note 1
Security Patrol	12,000	1,000	Note 1
Utilities	12,000	11,000	Note 1
Indirect Labor	4,457,545	1,594,070	Note 3
TOTALS	<u>\$ 5,475,000</u>	<u>\$ 1,773,350</u>	

1. Questioned cost represents the variable portion of each account. The amounts allowed in the pool under the Eichleay method include only fixed costs, since the variable portion of overhead ceases to exist during the delay period. The contractor agreed to eliminate these variable components.

2. These items are expressly unallowable under FAR Part 31; the contractor agrees to the questioned amounts.

3. The contractor improperly included off-site labor expenses within the on-site field pool. The contractor agreed to eliminate these costs from its calculation.

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Figure 10-11-1c

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Figure 10-11-1c (Ref 10-1106.1)
Evaluation of Proposal or Claim for Equitable Adjustment

Audit Report No. _____

Appendix 1
Page 1 of 1

EQUITABLE ADJUSTMENT PROPOSAL OR CLAIM

Filed under Changes Clause () or Disputes Clause (x)
Contract No. N00999-82-C-1234
Board of Appeals Case No. 33333

Contractor Name XYZ Company Telephone (703) 274-7775
Outside Proposal or Claim Preparer Samuel Jones Telephone (703) 274-7776
Trial Attorney Name Portia Barrister Telephone (202) 514-0832
Date of Initial Price Proposal 21 Aug 82 (compet. bid) Amount \$1,000,000
Date of Basic Contract 30 Sep 82 Amount \$1,000,000
Contract Type Firm Fixed Price-Competitive
Total Amount of All Modifications \$500,000
Date(s) of Alleged Abnormal Condition(s) 1 Oct 82 - 15 Jan 84
Description: XYZ Company alleges that the government provided defective specifications and equipment which resulted in increased costs.
Contract Specified Performance Dates: From 1 Oct 82 to 30 Sep 83
Actual Performance Dates: From 29 Jan 84 to 30 Sep 86

CHRONOLOGY OF SIGNIFICANT EVENTS

Event	Date
Contractor alleges defective specifications	1 Oct 82
Contractor submits site drawings	15 Mar 83
Contracting officer rejects drawings as nonconforming to contract specifications	16 Mar 83
Contractor protests PCO's action, requests 180-day delay	17 Mar 83
Contracting officer rejects contractor's request	27 Jun 83
Contractor submits revised drawings	24 Aug 83
Contracting officer approves revised drawings	22 Nov 83
Contractor alleges defective GFE	10 Jan 84
Contracting officer notifies contractor of proposed termination for default	15 Jan 84
Performance begins; TFD withdrawn	29 Jan 84
Contractor submits equitable adjustment proposal	22 Apr 84
Claim submitted	22 Aug 86
Claim certified under Contract Disputes Act	22 Aug 86
Contracting officer determines contractor is not entitled to an equitable adjustment and issues final decision	24 Aug 86
Contractor files ASBCA appeal	23 Nov 86
Audit request	29 Nov 86

10-1200 Section 12 — Audit Reports on Other Areas**10-1201 Introduction**

This section provides guidance for preparing audit reports on contract audit areas not covered in Sections 3 through 11 of this chapter. Audit reports on other areas should be adapted to the specific audit performed. As examples, suggested formats for audit reports resulting from reviews of progress payments and cost/schedule status reports are given in Figures 10-12-1, 10-12-2, and 10-12-3, respectively.

**10-1202 Additional Guidance
Applicable to Principal Types of
Reports**

The principal audit areas to which the guidance in this section is applicable are listed below. Reference is made to the paragraphs setting forth pertinent information on data to be reported and report distribution.

- (1) Audit Reports Pertaining to Suspected Fraud and Unlawful Activity (4-702.5).
- (2) Voluntary Disclosure Program (4-707.3).
- (3) Voluntary Refunds (4-802.4).
- (4) Contractor Financial Capability Reviews and Financial Jeopardy Reporting (14-307).
- (5) Progress Payments (14-206).
- (6) Contract Funds Status Reports (11-303.5).
- (7) Cost Performance Reports (11-304.4).
- (8) Cost/Schedule Status Reports (11-305.4).
- (9) Contractor Cost Data Reports (11-306.9).
- (10) Contractor Records of Government Property (14-408).
- (11) Military Dependents Medical Care Program (14-902.3).
- (12) Advance Payments (14-904.4).
- (13) Special Reviews Related to Government Rights in Inventions (14-906.4).
- (14) Special Information Reports for NASA (15-106.4).

(15) Specific information requirements for reports under Agency for International Development contracts (15-107 and 13-704).

(16) Claim for Exemption from Submission of Certified Cost or Pricing Data (14-907.3).

**10-1203 Format and Content of
Reports**

Prepare reports following the standard aspects of report preparation in 10-100 and 10-200 and the professional standards for audit reporting in Chapter 2. The auditor will also be guided by the reporting concepts contained in Sections 2 through 11 of this chapter and the comments that follow. The report should contain all necessary and pertinent information to be fully responsive to the needs of the recipient. As a minimum, all audit reports should include:

Purpose and Scope of Audit
Circumstances Affecting the Audit,
when applicable
Summary of Audit Results
Disposition of Audit Results

Other paragraphs, exhibits, schedules, and appendices as provided by 10-200 will be added to the report when appropriate.

**10-1204 General Comments on
Content of Report Paragraphs**

Since this section applies to a variety of audit areas, it is imperative that the "Purpose and Scope of Audit" and the "Summary of Audit Results" paragraphs be tailored to meet the specific requirements of the audit. Be sure the report does not imply acceptance for purposes other than those intended. For example, a progress payment audit report should not be misconstrued as determining the acceptability or allowability of costs claimed on the contractor's progress payment request.

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¶10-1204.1

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10-1204.1 Purpose and Scope of Audit Paragraph

This paragraph should define why the audit was performed and set forth the scope of audit. Most of the audits covered in this section are performed in response to requests. In such cases, the request should be referenced.

10-1204.2 Circumstances Affecting the Audit Paragraph

This paragraph sets forth any factors which have a significant adverse impact on the scope of audit and usually result in a qualified audit report. These circumstances include denial of access to records, nonreceipt of a technical evaluation report, insufficient time to perform the evaluation, etc. The exhibit, schedule, or appendix which contains detailed discussion of the item involved should be referenced.

10-1204.3 Summary of Audit Results Paragraph

This paragraph of the narrative tells the recipient what the audit findings are. If required, this paragraph should be supported by exhibits, schedules, and appendixes. This paragraph should also caution the reader to use the report for the purpose for which it was written.

10-1204.4 Disposition of Audit Results Paragraph

This paragraph should provide a point of contact and the FAO's telephone and FAX numbers. See also 10-209.4 for other required report comments.

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Figure 10-12-1

**Figure 10-12-1 (10-1201)
Example of an Audit Report on
an Audit of a Progress Payment Request
(NEGATIVE ASSURANCE/NO EXCEPTIONS)**

1. Purpose and Scope of Audit

a. In response to your [insert date] request, reference [insert number], we have audited the XYZ Company progress payment request submitted with Invoice No. [insert number] under prime contract No. [insert number]. The purpose of the audit was to verify the amount claimed through 31 July 19XX to the contractor's books and records as a basis for approving contract financing through progress payments in accordance with the provisions of the contract. The contractor's financial records and related supporting data are the responsibility of the contractor. Our responsibility is to express an opinion on the progress payment request based on our audit.

b. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion. We did not perform the customary auditing procedures to determine the allowability of costs under FAR Part 31 [and (identify specific agency supplement, if any)], since such procedures will be performed to establish the final contract price, if required.

[Notice that the scope paragraph states that no tests were performed to determine the allowability of the costs claimed.]

c. Because no loss is anticipated on the contract, the risk that [name of contractor] will not be financially capable of completing the contract was sufficiently low that it was not necessary to test for financial capability. Moreover, in connection with our audit of the progress payment request, nothing came to our attention that caused us to believe that the contractor will not be financially capable of completing the contract.

[Notice the negative assurance relative to financial capability.]

2. Summary of Audit Results

a. In our opinion, the contractor's progress payment request of \$25,000, based on costs incurred through 31 July 19XX, has been computed in accordance with contract terms and is considered acceptable for progress payment. The audit disclosed no weaknesses in the contractor's internal control procedures which would necessitate a restriction of contract financing through progress payments.

b. We discussed the results of audit with the contractor's representative, [insert name and title of individual].

c. The information in this report pertains only to the subject audit. It should not be used for other purposes without first consulting us.

3. Disposition of Audit Results

a. We will be pleased to provide accounting counsel and any additional audit service which the contracting officer may require in connection with this report and the implementation of our recommendations. Requests for assistance should be directed to [name], Supervisory Auditor, at telephone number _____ or fax number _____.

b. Please provide any comments or suggestions you may have on this report and on the related audit support.

Figure 10-12-2 (10-1201)

**Example of an Audit Report on
an Audit of a Progress Payment Request
(POSITIVE ASSURANCE/LOSS CONTRACT)**

1. Purpose and Scope of Audit

a. In response to your [insert date] request, reference [insert number], we have audited the XYZ Company progress payment request submitted with Invoice No. [insert number] under prime contract No. [insert number]. The purpose of the audit was to verify the amount claimed through 31 July 19XX to the contractor's books and records as a basis for approving contract financing through progress payments in accordance with the provisions of the contract. The contractor's financial records and related supporting data are the responsibility of the contractor. Our responsibility is to express an opinion on the progress payment request based on our audit.

b. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion. We did not perform the customary auditing procedures to determine the allowability of costs under FAR Part 31 [and (identify specific agency supplement, if any)], since such procedures will be performed to establish the final contract price, if required.

[Notice that the scope paragraph states that no tests were performed to determine the allowability of the costs claimed.]

2. Summary of Audit Results

a. In our opinion, based on cost incurred through 31 July 19XX, the contractor's requested progress payment amount of \$380,000 is overstated by \$323,840.

b. The contractor's financial condition is considered adequate for the performance of the contract. The audit disclosed no weaknesses in the contractor's internal control procedures which would necessitate a restriction of contract financing through progress payments.

1 [Notice the positive assurance relative to financial capability (See 14-206b). This statement can only be made if the the audit procedures discussed in 14-300 relative to financial capability have been performed.]

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Figure 10-12-2

c. Our recommended adjustments result in a maximum balance eligible for progress payments of \$56,160, which is based on the application of a loss-ratio factor as prescribed in FAR 32.503-6(g). Details follow:

		Results of Audit	Ref.
<u>Adjustments to Contractor's Progress Payment Request</u>			
<u>SECTION I</u>			
Item 5: Contract Price		<u>\$2,600,000</u>	
<u>SECTION II</u>			
Item 12a: Total Costs Incurred to Date		\$1,600,000	
Item 12b: Estimated Additional Cost to Complete (ETC)		+ <u>1,879,000</u>	(1)
Total Estimated Cost at Completion (EAC)		= <u>\$3,479,000</u>	(1)
Loss-Ratio Factor Calculation:			
Contract Price	\$2,600,000		
EAC	+ <u>3,479,000</u>		
Loss-Ratio Factor	= <u>74.7%</u>		
Item 11: Total Costs Eligible for Progress Payment		\$1,600,000	
Loss-Ratio Factor	×	<u>74.7%</u>	
Recognized Costs Eligible for Progress Payments	=	\$1,195,200	(2)
Item 6a: Progress Payment Rate	×	<u>80%</u>	
Item 13: Item 11 multiplied by Item 6a	=	\$ 956,160	(3)
Item 18: Total Amount of Previous Progress Payments Requested	-	<u>900,000</u>	
Item 19: Maximum Balance Eligible for Progress Payments	=	<u>\$ 56,160</u>	
Contractor's Requested Progress Payment Amount	=	<u>\$ 380,000</u>	
Overstated Amount	=	<u>\$ 323,840</u>	

(1) The contractor's ETC represents the difference between the latest EAC dated 31 July 19XX and the total costs incurred through 31 July 19XX. No exception was taken to the contractor's latest EAC.

(2) The Recognized Costs Eligible for Progress Payments represent the contractor's total costs eligible for progress payments adjusted to exclude the forecasted loss on the contract.

(3) Represents the total amount eligible for progress payments after the contractor's forecasted loss has been excluded.

d. We discussed the results of audit with the contractor's representative, [insert name and title of individual], who concurred with our recommendation.

e. The information in this report pertains only to the subject audit. It should not be used for other purposes without first consulting us.

3. Disposition of Audit Results

a. We will be pleased to provide accounting counsel and any additional audit service which the contracting officer may require in connection with this report and the implementation of our recommendations. Request for assistance should be directed to [name], Supervisory Auditor, at telephone number _____ or fax number _____.

b. Please provide any comments or suggestions you may have on this report and on the related audit support.

Figure 10-12-3 (10-1201)

**Example of an Audit Report on an Audit of
a Contractor's Cost/Schedule Status Report**

1. Purpose and Scope of Audit

a. In response to your [insert date] request, reference [insert number], we have audited [insert the name of the contractor]'s cost/schedule status report (C/SSR) to determine if the contractor has established adequate and effective policies and procedures for developing and reporting actual and projected contract costs. The contractor's financial records and related supporting data are the responsibility of the contractor. Our responsibility is to express an opinion on the C/SSR report based on our audit.

b. Except as discussed in paragraph 2 below, we conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the contractor, as well as evaluating the overall data and records presentation. We believe that our audit provides a reasonable basis for our opinion. We did not perform any auditing procedures to determine the allowability of costs under FAR Part 31 [and (identify specific agency supplement, if any)].

[Notice that the scope paragraph states that no tests were performed to determine the allowability of the costs incurred.]

2. Circumstances Affecting the Audit

a. Our audit of the contractor's cost/schedule status report included examination of the estimate to complete. In order to determine the reasonableness of the contractor's estimate to complete, we requested technical specialist assistance from [enter the organization of the technical specialist]. However, the technical report was not received in time for incorporation into our report. Of particular concern is the contractor's electrical engineering judgmental estimate of labor hours necessary to design and produce the antenna transmission unit. The estimate to complete the antenna unit represents 80 percent of the total estimated cost to complete.

b. Our audit of the contractor engineer's judgmental estimates revealed no supporting data that the auditor could test. Accordingly, the assumptions used to develop these estimates need to be evaluated by an electrical engineer knowledgeable in the area. Therefore, the results of audit are qualified to the extent that the accuracy of the contractor's estimate to complete may be questioned based on the results of the technical evaluation. Refer to [enter exhibit, schedule, or appendix where details are provided]. This technical issue is considered significant enough to materially impact the results of audit. We recommend that the auditor be given an opportunity to review the results of the technical specialist's evaluation, determine the impact upon the scope of audit and overall conclusions, and provide a supplemental report incorporating the results of such evaluation

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Figure 10-12-3**

for use by government personnel relying on the contractor's status reports. We anticipate receipt of the report of technical evaluation on or about [insert date].

3. Summary of Audit Results

a. In our opinion, subject to the qualification noted in paragraph 2, the contractor's C/SSR policies, procedures, and internal controls provide accurate actual and projected costs on contracts covered by DoD Manual 5000.2-M, Part 20, Cost Management Reports.

b. We discussed the audit results with the contractor's representative [insert name and title of individual].

c. The information in this report pertains only to the subject audit. It should not be used for other purposes without first consulting with us.

4. Disposition of Audit Results

a. We will be pleased to provide accounting counsel and any additional audit service which the contracting officer may require in connection with this report and the implementation of our recommendations. Requests for assistance should be directed to (name), at telephone number _____ or fax number _____.

b. Upon receipt of the technical report, we will issue a supplemental report, if it will serve a useful purpose.

c. Please provide any comments or suggestions you may have on this report and on the related audit support.

NOTICE

During the finalization of this CAM update, the Agency adopted the new audit report format described in MRD 94-PFD-163, dated 26 September 1994. FAOs began using the new format 31 October 1994 and sample audit reports using the new guidance were added to the DCAA Bulletin Board under the file name NUFORMAT.ZIP.

At this printing, Chapter 10 is only partly revised to incorporate the new report format guidance (i.e., 10-400). During the transition, auditors should adapt the guidance in Chapter 10 to the reporting format in MRD 94-PFD-163 and the examples in NUFORMAT.ZIP.

Watch for cc:Mail announcements of updates to NUFORMAT.ZIP.

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CHAPTER 11

11-000 REVIEW OF CONTRACTOR COMPLIANCE WITH
CONTRACT FINANCIAL MANAGEMENT REQUIREMENTS

11-001 Scope of Chapter

This chapter provides guidance that is peculiar or special to the accomplishment of the review of contractor compliance with contract financial management re-

quirements. To the extent appropriate under the circumstances, Chapters 3, 4, 5, and 6 of this manual are equally applicable to the audit assignments discussed in this chapter.

11-100 Section 1 — Review of Contractor Compliance with “Limitation of Cost,” “Limitation of Funds,” and “Limitation on Payments” Clauses

11-101 Introduction

This section provides guidance for reviewing contractual limitations on costs, funds, and payments.

the procuring agency may require additional reporting, or the contractor may prepare other internal reports in addition to those required by the government.

11-102 General

Contract limitation of cost clauses (FAR 52.232-20 and 21) and limitation of funds clause (FAR 52.232-22) contain financial reporting requirements for cost-type contracts. The contract limitation on payments clauses (FAR 52.216-5, 6, 16, and 17) contain financial reporting requirements for contracts with price redetermination provisions and fixed-price incentive contracts. The limitation of cost clause in cost-type contracts requires the contractor to advise the contracting officer when there are indications that the total cost for the performance of a contract will be substantially greater or less than the estimated total contract cost. The limitation on payments clause in contracts with price redetermination provisions and fixed-price incentive contracts requires the contractor to report to the contracting officer the costs in relation to billing prices on items for which final prices have not been established. The objective of Limitation on Payments Statement quarterly submissions is to keep billing rates during contract performance in line with expected final prices; indicated overpayments can be recouped and excessive billing rates adjusted on a timely basis. This is a minimum requirement. The contract or

11-103 Scope of Review

Knowing the management tools available to a contractor in controlling, projecting and monitoring contract costs is of utmost importance. Obtaining this knowledge is an integral part of functional reviews aimed at determining the adequacy of contractor financial management systems. It is important for the auditor to ascertain that the contractor has the financial management tools necessary to adequately identify potential contract overruns or underruns. The auditor should promptly notify the contractor and the ACO of any deficiencies. In reviewing and evaluating the contractor's financial management policies and procedures, the auditor should ascertain:

a. The nature and adequacy of controls which govern the establishment of budgets; the procedures for accumulating incurred costs by budget element; the actual cost compared to budgeted costs; the means provided for comparing incurred costs to the percentage of contract completion; and development of estimates to complete (ETCs).

b. Whether the contractor's organization effectively utilizes its financial management tools to promptly report potential cost overruns and underruns to contractor management and subsequently to the government.

c. The methods by which the overall contract financial controls relate to the day-to-day supervisory controls maintained at the operational level.

11-104 Review Procedures

The audit procedures suggested in this section are not intended to be all-inclusive; the auditor, after considering these guidelines, must develop an audit program based on individual circumstances.

11-104.1 Determination of Reporting Requirements

When appropriate, the auditor should:

a. Determine, from contract briefing files or other available sources, those contracts which require limitation of cost reports, limitation of funds reports, or limitation on payments statements.

b. Ascertain whether the contractor is required to meet additional reporting requirements not specifically required by the contract.

c. Ascertain whether internal reports, in addition to those required by the contract, are prepared to increase internal financial management controls. If so, they should be compared with the reports submitted under the contract to determine whether significant differences exist.

d. Compare the reporting requirements among various contracts and determine whether there is duplication in the reports required and in the information assembled. The auditor should consider the possibility of the contractor using reports required by one military department, command, or Service to satisfy the needs of all contracting officers.

11-104.2 Evaluation of Reporting Controls

When appropriate, the auditor should:

a. Review and evaluate the contractor's procedures applicable to the budgetary controls of individual contracts and compare the estimated cost of individual tasks and departments in the cost estimate with the budgeted funds.

b. Ascertain and evaluate for each division (or plant) the internal procedures for controlling the financial status of government contracts and determine

the source of the reported incurred costs and the basis for ETCs. The auditor also should determine the extent and frequency of supervisory reviews of the status reports and whether explanations are required when there are significant deviations from the budget.

c. Ascertain and evaluate the manner in which revised ETCs, in terms of engineering and production man-hours, relate to the production control schedules and engineering manpower schedules at specific work centers.

d. Evaluate the documentation flow of the financial status reports from the various sources to the finance manager responsible for preparing the overall financial report for the assigned project.

e. Evaluate the controls exercised by the finance manager, including (1) the manner in which the source data are reviewed for reliability, (2) the basis for changes to the source data, and (3) a determination of the extent to which requests for explanations from operations responsible for the source data are made relative to causes of potential cost overruns or underruns.

11-104.3 Audit Objectives

The audit objectives are (1) to determine whether the contractor has complied with the reporting requirements contained in the contract clause and (2) whether the financial data contained in the contractor's reports and statements are reasonable and consistent with the data presented in other required government reports and/or claims.

11-104.4 Audit Guidelines

The review guidelines which are applicable to the minimum reporting requirements in 11-102 are as follows:

a. Ascertain whether the contractor is submitting reports required by its contracts. Compare these reports with the contractor's internal financial reports for consistency.

b. Review limitation of cost reports. The limitation of cost clause requires the contractor to provide the contracting officer advance notice whenever the total cost incurred on the contract will exceed a specified percentage of, or will be greater or substantially less than, the

estimated cost specified in the contract. The contractor must submit a revised estimate of the total cost of performing the contract as part of the notification. Limitation of cost reports should be evaluated using the following guidance:

(1) Review the contractor's revised EAC using the guidance in CAM 14-205f.

(2) Ascertain whether the limitation of cost reports in successive periods reflect significant cost underruns or overruns.

(3) Ascertain whether the contracting officer has obtained contractor explanations for overruns when continuous overruns have occurred over an extended period.

(4) When continuous underruns are projected over an extended period, and when the overall estimated contract price has not been reduced, the auditor should ask the contracting officer why.

(5) When individual contracts indicate continuous significant cost overruns or underruns, the auditor should evaluate this condition in relation to the price established at the time of award. If it is determined that consistent overruns or underruns resulted from defective initial pricing, the contracting officer should be so advised.

c. Review limitation of funds reports. The limitation of funds clause requires the contractor to provide the contracting officer advance notice whenever the total cost incurred on the contract will exceed a specified percentage of the funds currently allotted or, for cost sharing contracts, this amount plus the contractor's corresponding share. This notice must include an estimate of the amount of additional funds required to continue performance for the period specified in the contract. Limitation of funds reports should be evaluated using the guidance in 11-104.4b above.

d. Review limitation on payments statements. Limitation on payments (LOP) statements must be submitted quarterly, in accordance with the provisions of FAR 52.216-5, 6, 16, or 17. The primary objectives of LOP statements are to provide for recoupment of overpayments and to indicate a need for a reduction in billing prices. These conditions become apparent when the contractor is underrunning targets used to estab-

lish billing prices. Overruns are indicated when estimated final prices exceed invoice amounts. This indicates possible need for increased billing prices and/or revision of liquidation rates. The general objective is to keep billing prices in line with expected final prices during contract performance. Progress payments and LOP statements should be reviewed at the same time. Even though a request for audit may specify a particular document, auditors should try to identify both submissions with comparable cutoff dates for direct comparison and reconciliation. Evaluate LOP statements and reconcile them to progress payment requests using the following guidance:

(1) The auditor should determine that costs related to delivered items are the same as the amounts excluded from costs shown as a basis for unliquidated progress payments (Item 20a of the progress payment request).

(2) The price of items invoiced should be the same as Item 21a on the progress payment request when both submissions have the same cutoff date.

(3) The EACs used to prepare LOP statements and progress payment requests should be the same. The most current estimates should always be used. EACs should be evaluated using the guidance in CAM 14-205f.

(4) The auditor should assure the comparability of contract items used in computations required by the various subsections of the Limitation of Payments Statement. In all instances, cost data should relate to supplies and services delivered and accepted.

(5) The auditor should determine the methods used by the contractor to identify actual costs of delivered and invoiced items. Understatement of this amount usually results in an overpayment of progress payments by overstating the costs eligible for progress payments applicable to undelivered and uninvoiced items.

(6) The auditor should ascertain whether the contractor makes prompt refunds or adjustments when cost underruns are indicated in the performance of fixed-price redeterminable contracts.

11-104.5 CAS Compliance

The auditor should determine if reporting practices comply with CAS 401, "Consistency in Estimating, Accumulating, and Reporting" (See Chapter 8).

11-105 Reports

Reports will be furnished in response to specific requests for evaluations in this

area. Audit reports will be prepared in accordance with 10-400. When there is reason to recommend correction of a substantial deficiency, a special report will promptly be initiated by the auditor even if there is no request from a contracting officer. Other deficiencies may be included in periodic reports on the overall system of accounting and internal control.

11-200 Section 2 — Review of Contractor Compliance with Cost/Schedule Control Systems Criteria (C/SCSC)**11-201 Introduction**

This section provides guidance for reviewing contractor management systems on selected weapons systems contracts. Also, as appropriate, see the guidance in 9-1300 regarding joint team reviews. The minimum criteria that must be met by the contractor are prescribed in DoD Instruction 5000.2, Part 11, Section B.

11-202 Performance Measurement**11-202.1 Introduction**

a. DoD Instruction 5000.2, Part 11, Section B, "Contract Performance Measurement," prescribes the minimum criteria for a contractor's management system to effectively manage selected weapons systems contracts. Part 11, Section B, of the Instruction, and its attachments, "Cost/Schedule Control Systems Criteria," and Cost/Schedule Control Systems Criteria Definitions, are reproduced in 11-2S1. The criteria represent the framework for an integrated management system that provides for (1) planning the timely performance of work, (2) budgeting resources, (3) accounting for costs and measuring actual performance against plans, and (4) replanning resources needed to complete the contract when significant deviations from plans are identified. There are 35 criteria that a contractor's management system must meet, and they are organized into the following five major categories: Organization, Planning and Budgeting, Accounting, Analysis, and Revisions and Access to Data. Detailed uniform guidance for implementing the criteria and conducting systems reviews is provided in the Cost/Schedule Control Systems Criteria Joint Implementation Guide (DCAAP 7641.47).

b. The referenced DoDI provisions are applicable to contracts within programs which have an estimated RDT&E cost of \$60 million or more or procurement contracts with a value of \$250 million or more (in fiscal year 1990 constant dollars). Firm-fixed-price contracts (includ-

ing fixed-price contracts with economic price adjustment provisions), time-and-materials contracts, and contracts which consist mostly of level-of-effort work are excluded. However, in any event the auditor must refer to the specific terms of the contract to determine whether the contract contains reporting requirements for cost/schedule control (C/SC) systems criteria. Audit participation in C/SC system implementation and surveillance reviews is required by paragraph 4-b of DoDI 5000.2, Part 11, Section B; general responsibilities of the auditor during system implementation (Phase I) and system surveillance (Phase II) are delineated in the C/SCSC Joint Implementation Guide and the Cost/Schedule Control Systems Criteria Joint Surveillance Guide (DCAAP 7641.46), which supplements and elaborates on the provisions of the DoD Instruction.

11-202.2 Evaluation Reviews

An evaluation review, as distinguished from a demonstration review, is a review of a contractor's description of its internal management control system. It is normally accomplished prior to the award of a weapons system contract and consists of an analysis of the prospective contractor's description of its performance measurement system, as in its response to the government's request for proposal. If a contractor has proposed to use a previously accepted system, the cognizant auditor will provide comments in the price proposal audit report Appendix on Other Matters on how well the contractor's C/SC system is meeting the criteria on other contracts (9-316b). An on-site review of the operation of the performance measurement system is not ordinarily required during the evaluation review and, accordingly, audit assistance will not usually be requested. However, when any part of the system is not clearly understood, an on-site review may be necessary to clarify that particular aspect of the total system. If an on-site review is deemed necessary, and the assistance of the auditor is desired, the procuring

service will notify the cognizant auditor as soon as possible. The auditor will be responsive to the procuring service for evaluation of those accounting and/or financial aspects of the contractor's system.

11-202.3 Demonstration Reviews

a. Following contract award, the contractor is required to demonstrate that its management system operates as described in the proposal and/or as required by the contract. The demonstration review is conducted by a DoD team, the leader of which is appointed by the procuring military department, or, in the case of bi-Service or tri-Service reviews, by the lead military department. The team includes a DCAA auditor. Team members should be advised of the estimated review starting date in advance and furnished information about the contractor's management system and Demonstration Review Plan.

b. Generally, the team will conduct a preliminary implementation visit and a readiness assessment before the full-scale demonstration review. DCAA may or may not be invited to participate in these preliminary reviews. The implementation visit is to determine if the contractor's plan for demonstrating compliance with C/SC systems criteria is sufficient. The readiness assessment is to assess the contractor's ability to demonstrate a fully operational management control system.

c. A system for controlling development effort is generally different from a system for controlling production work; accordingly, separate demonstration reviews are ordinarily required for each although only one program may be involved. Separate validations are issued when and as the contractor's system meets C/SC systems criteria. At the conclusion of the demonstration review, the team leader will be responsible for the preparation of the Demonstration Review Report. This report will serve as a basis for a decision on whether the contractor's system complies with the C/SC systems criteria. If the system is not acceptable, corrective action must be initiated by the contractor. After appropriate corrective action has been completed, another demonstration review is

required in those areas which were deficient or inadequate, making full use of the information and data developed in the initial demonstration review.

11-202.4 Extended Subsequent Application Reviews, Subsequent Application Reviews, and Baseline Reviews

a. Contractors whose management control systems were accepted for application to another contract of the same type (e.g., development or production) at the same facility will not be required to undergo a demonstration review on a new contract unless significant modifications have been made to the previously accepted systems, or surveillance (11-204) reveals that the accepted systems have not been operated as contractually agreed to in the prior contract. Depending on the circumstances, an extended subsequent application review, subsequent application review, or baseline review may be performed to determine that the previously validated system and approved changes thereto are being used in an acceptable manner on new contracts with requirements of C/SC systems criteria. Although not as comprehensive as the initial demonstration review, they are of equal importance to the continued successful implementation of C/SC systems criteria.

b. An extended subsequent application review (ESAR) is performed when a contractor has a previously accepted system but wishes to extend it from one program phase to another, such as from development to production, from one contractor facility to another, or from the validated C/SC system description to an extensively revised system description.

c. A subsequent application review (SAR) is performed when a contractor is awarded a contract to be performed at a facility where the management control system has been previously accepted for the same type of contract (i.e., development or production). The objective of the review is to ensure that the contractor is properly and effectively using the accepted system, revised in accordance with approved changes, on the recently awarded contract.

d. A baseline review is conducted to determine on a very limited basis that a contractor is continuing to use the previously accepted management control system and is properly implementing a baseline on the contract under review. It should only be considered when the review is to be scheduled within one year of a successful demonstration review, ESAR, or SAR, when otherwise justified by the procuring activity and approved by the applicable Service C/S focal point, and when there are no significant outstanding deficiencies being reported by the Contract Administration Office (CAO).

11-202.5 Surveillance Reviews

Immediately following demonstration and acceptance of the contractor's management control system, surveillance by DCAA and the Contract Administration Office will be performed to ensure that the contractor's system continues to comply with the C/SC systems criteria and produces valid and timely data. Surveillance is also performed to ensure that any proposed or actual changes to the management control system comply with the criteria and are reflected in the contractor's system description. Surveillance will provide for verifying, tracing, and evaluating the information contained in the reports submitted to DoD procuring components. In the event deficiencies are disclosed, or if there is an indication of an adverse effect on contract performance because of such deficiencies, the CAO C/SC monitor and the contractor should be promptly informed.

11-203 Audit Objectives, Scope, and Procedures during Evaluation Reviews, Demonstration Reviews, ESARs, SARs, and Baseline Reviews (System Implementation Reviews)

Upon receipt of a specific request, the applicable FAO will assign an auditor to be a member of the evaluation, demonstration, ESAR, SAR, or baseline review team. Auditors assigned to these teams should be familiar with the Cost/Schedule Control Systems Criteria Joint Implementation Guide and have

some training in C/SC systems criteria. Prior to the review, auditors should become thoroughly familiar with the contractor's C/SC system by reviewing the contractor's system description and analyzing cost management reports (11-300) for the contract under review.

11-203.1 Audit Objectives

The auditor's primary objective is to review the accounting system and related financial areas to determine whether the management control system complies with the C/SC systems criteria on areas assigned and is being implemented on the contract under review. The auditor is responsible for advising the team chief, on the areas reviewed, of the conclusions and will be responsible to the team chief for the timely completion of the effort specifically assigned. As members of a C/SC systems criteria review team, auditors may be involved in cost account/functional manager interviews, questionnaire completion, discrepancy report preparation, documentation reviews, and review report preparation. Auditors should perform as much preliminary work as possible in advance of the team visit in order to provide conclusions on any C/SC system deficiencies to the team chief by the end of the C/SC systems criteria review.

11-203.2 Scope of Audit

a. The DCAA team member is responsible for the preparation and execution of a detailed audit program for all areas assigned by the team chief. Technical direction will be provided by an audit supervisor. Auditors should also assess whether deficiencies disclosed in reports on MMAS, labor, other accounting systems, forward pricing rates, budgets, and billing systems are likely to affect the contractor's C/SC system. If the contractor has other contracts requiring an approved C/SC system, the auditor should also determine if deficiencies being reported in C/SC systems surveillance reports (11-204) have an impact on the contract under review.

b. The auditor is responsible for advising the team chief, on areas reviewed, whether the management system meets the requirements of the C/SC systems

criteria. Unresolved disagreements should be referred to the regional office and, when necessary, to DCAA Headquarters, Attn: O. The report should be qualified and should recommend that the system not be validated when (1) unacceptable accounting policies or practices have a substantial impact on system operation or output, and/or (2) access to budgetary data or operating forecasts necessary for system validation is lacking. Additional guidance on access to data is provided in paragraph e. below.

c. If the auditor becomes aware of significant accounting or financial aspects of the contractor's system that have been omitted from the evaluation review, demonstration review, ESAR, SAR, or baseline review and an inadequate system may thus be validated, the circumstances should be immediately brought to the attention of the team chief and documented in the DCAA files. Comments on these matters should also be included in the audit report together with statements regarding their expected impact on the system and related reporting of contract performance.

d. A C/SC system is intended for contractor use in managing contracts and for government use in monitoring contract performance. Application of the provisions of DoDI 5000.2 should not result in the development or use of two systems, one for the contractor's internal use and the second merely to satisfy the intent of the criteria. Evidence of intended or actual parallel operation should be fully evaluated and the results discussed with other members of the C/SC systems criteria review team. A determination that only one system will be used is necessary prior to validation of the proposed C/SC system.

e. Unrestricted access to all data affecting contract costs, both direct and indirect, including budgets and operating forecasts, is necessary to properly validate a C/SC system. If the contractor refuses access to required data, the auditor will advise the team chief and the CAO C/SC system monitor and enlist their aid in obtaining the information. If the contractor continues to deny access, the auditor will recommend, in writing, that the system not be validated. In the

event that access to required data is made available during the validation process but the auditor has been formally advised by an authorized representative of the contractor that the data will be withheld during the surveillance phase, a comment to that effect will be included in the validation audit report, together with a statement that lack of access to data may result in qualification of system surveillance audit reports.

f. In addition to serving as a C/SC systems criteria review team member, auditors are responsible for monitoring contractor corrective action in assigned areas. If the contractor fails to take effective corrective action or fails to make acceptable progress in resolving deficiencies, contractual remedies should be recommended (e.g., withhold progress payments, disallow costs).

g. In those cases when management control acceptance is delayed for an extended period of time after contract award because the system has not been fully accepted or has been found to be unacceptable, DCAA surveillance activities should concentrate on verification of reported data and consistency between cost and schedule information and information from other contractor systems.

11-203.3 Audit Procedures

a. Select those tests and other auditing procedures that are necessary to adequately complete the work assigned. These procedures will include tests to verify that the management control system meets the criteria for the areas assigned. Make maximum use of prior reviews and knowledge accumulated by the resident audit staff so as to avoid duplication of effort. However, auditors should conduct sufficient tests of the assigned criteria during each C/SC systems criteria review to confirm that the management control system has in fact been implemented on the contract under review.

b. In evaluating whether a contractor's management control system complies with the criteria, the auditor should conduct audit procedures similar to those performed during surveillance of the C/SC systems criteria (11-204). Criteria which DCAA is commonly asked to

review include: Organization Criterion 4, Planning and Budgeting Criterion 9, all of the Accounting Criteria, and Analysis Criteria 3 and 6. The team members should use the Evaluation/Demonstration Review Checklist for C/SCSC, Appendix E of the Cost/Schedule Control Systems Criteria Joint Implementation Guide (DCAAP 7641.47), as necessary in the examination of contractor management control systems to ensure compliance with the criteria. This checklist includes a restatement of criteria followed by specific questions or areas to be addressed by the review team. Auditors will need to design specific audit steps to answer these questions.

c. The auditor's supervisor will provide technical direction to assure the proficiency of the work performed. All work will be reviewed by the supervisor prior to forwarding reports or conclusions to the team chief. 11-203 Audit Objectives and Procedures during Evaluation and Demonstration Reviews

11-204 Audit Objectives and Procedures for Surveillance Reviews

a. Basic auditor responsibilities of the surveillance reviews are summarized in the C/SCSC Joint Implementation Guide; more specific audit guidance is provided in subsequent paragraphs.

b. A written description of the validated management control systems should be furnished to the auditor by the Demonstration Review team leader. The description should be included in the permanent files and used for planning the surveillance review program.

c. Periodic reviews should be made of the contractor's performance measurement policies, procedures, and practices to determine whether the contractor is continuing to operate the system as originally validated by the Demonstration Review team, subject to any authorized or other contractual changes. The frequency and scope of audit should be predicated on (1) the adequacy of accounting procedures and controls and the effectiveness with which they are implemented, (2) the quality of available evidential matter, (3) the results of prior surveillance reviews, (4) the extent of

internal reviews performed in the C/SCSC area, and (5) deficiencies noted in other contractor systems, such as billing, budgeting, compensation, EDP, estimating, general accounting, indirect and other direct cost accounting, labor cost accounting, material management and accounting, and purchasing. Reviews should be performed at least once a year, although tests of certain aspects of the system (i.e., evaluation of variance analyses, data reconciliations, system integrity, and estimates to complete) should be performed as frequently as necessary to ensure continued reliance on the system and related output.

d. To the extent possible, surveillance efforts should be integrated with the evaluation of other functional areas such as the estimating system, budget preparation, production scheduling and control, and other related contract financial management functions. To ensure adequate evaluation of the system and related output, and to preclude any duplication of effort, programmed surveillance should be coordinated with the military department or DCMC monitor. This coordination should include a discussion of those aspects of the system scheduled for review as contained in the FAO's annual plan. The program monitor should also be advised of other functional reviews scheduled which may relate directly or indirectly to the C/SC system. Formal agreement for surveillance activity should not be affected since the degree of surveillance required may vary considerably between contracts and from one period of contract performance to another.

e. Actual and proposed changes to any facet of the contractor's financial management system (budgeting, accounting, or reporting) should be evaluated in terms of their effect on the validated C/SC system. Existing or potential problems created by these changes should be discussed with the contractor and the resident ACO/government monitor to ensure prompt and correct resolution.

f. DoDM No. 5000.2, Part 20, Cost Management Reports, establishes the Cost Performance Report (CPR) as the primary reporting format for performance measurement of major defense

systems. As part of the review required in c. above, the auditor will selectively test the accuracy and reliability of data contained in the CPRs generated by the contractor's C/SC system and ensure that similar data presented in other reports, such as Contract Funds Status Report (CFSRs) and Contract Cost Data Reporting (CCDRs) for the same periods, are reconcilable to the data contained in the CPR. The CPR is discussed further in 11-304.

g. As a minimum, the procedures contained herein will be considered in developing an audit plan for review of a C/SC system. The plan should be related to programs developed for review of other functional areas to minimize the possibility of duplication of effort. Further, it is of paramount importance that the auditor be continuously alert to the fact that one of the basic objectives of a performance measurement system is to provide early disclosure of existing or potential cost growth conditions. Accordingly, particular emphasis should be placed on the areas of control for contract changes, variance analyses, and evaluations of estimates to complete.

11-205 Verification of BCWS, BCWP, and ACWP

The Performance Measurement Baseline is the time-phased budget plan against which contract performance is measured. It is formed by the budgets assigned to scheduled cost accounts and the applicable indirect budgets, which may also be known as the scheduled direct costs and applicable expense rates, and is sufficiently detailed to the work package level to ensure adequate performance measurement. The Budgeted Cost for Work Scheduled (BCWS) is the sum of budgets for all work packages scheduled to be accomplished and is the measurement of work scheduled to be accomplished within a given time period. The Budgeted Cost for Work Performed (BCWP) is the sum of budgets for completed work accomplished. The Actual Cost of Work Performed (ACWP) is the cost incurred and recorded in accomplishing the work performed within a given time period. Each of these terms

are precisely defined in DoD Instruction 5000.2, Part 11, Section B, Attachment 2, which is reproduced in 11-2S1. To ensure continued baseline integrity and to preclude distortion of performance measurement occasioned by unauthorized or arbitrary changes to the baseline and/or errors in the computation of the BCWS, the BCWP, or the ACWP, the auditor should periodically sample and test the accumulation of the BCWS, the BCWP, and the ACWP from the detail level to the contract summary level. The frequency and scope of such test will be dictated by the adequacy of the procedures used and the result of prior reviews. As a minimum, the following steps should be performed:

a. From the lowest levels, work packages, or cost accounts, the auditor should summarize the BCWS, the BCWP, and ACWP through the Work Breakdown Structure (WBS) to the contract level and the Cost Performance Report. This should be done for both the current month and cumulative to date amounts.

b. The auditor should verify the computation of the BCWS and the BCWP.

c. Amounts should be summations from the lowest points of accumulation without intermediate allocations.

d. Indirect cost and labor rates applied should be the originally planned rates for work scheduled and work accomplished; also verify that acceptable rates are used for actual costs.

e. The system should distinguish between recurring and non-recurring costs.

f. Material costs should be recorded by the applied material costs concept, when applicable.

g. Deficiencies disclosed or errors noted should be discussed with contractor personnel for subsequent correction. Schedule follow-up action required for subsequent surveillance reviews.

11-206 Contract Changes

Government-directed contract changes affect virtually all aspects of the contractor's internal planning and control system, including work authorizations, budgets, and schedules. Accordingly, the auditor should ensure that the procedures reviewed and accepted during the dem-

onstration/validation review are being followed by contractor personnel in effecting subsequent changes. Additionally, on a sample basis, contract changes should be reviewed to determine that:

a. The values of authorized changes have been incorporated into the baseline in a timely manner and effect given to the changes in estimates to complete, when necessary.

b. The estimated costs of undefinitized (authorized but unnegotiated) change orders have been incorporated into the baseline and, as required, adjustments made to the values of previous undefinitized changes subsequently negotiated.

c. Labor and burden rates used to plan effort required by changes represent rates expected to be experienced in the time frame in which the work is expected to be accomplished.

d. Continued integrity of the performance measurement baseline is necessary to ensure valid comparisons between work planned and work accomplished. Accordingly, changes to the baseline requiring government approval should not be made prior to government authorization. However, the very purpose of a C/SC system is to provide visibility to the contractor and the government to enable both parties to consider reprogramming or redirection of effort and to effect trade-offs between cost, schedule, and/or technical performance, when necessary. Therefore, procedures should be established by the contractor whereby data concerning pending but unauthorized significant changes are made known to the government. Further, indications of such changes disclosed during the course of surveillance activities should be reported together with estimated costs, if available.

11-207 Reconciliation of Reported Data

The purpose of reconciling external reports, such as the Cost Performance Report (CPR), Contractor Cost Data Reporting (CCDR), and the Contract Funds Status Report (CFSR) with each other and with contractor internal reports is to ensure that the information being reported is accurate and differences in

data from one report or level to another are logical, consistent, and explainable. The contractor should make the necessary reconciliations. The auditor should perform the following steps, on a selective basis, to ensure that the reasons for differences between reports or levels of reports are valid, consistent, and acceptable.

a. The auditor should verify reconciliations between the CPR and the CFSR for contract target, actual cost, and estimated final cost.

b. The auditor should verify reconciliations between the CPR-reported data or its equivalent and the contractor's summary level data.

c. When applicable, the auditor should verify reconciliations of internal-reported and CPR-reported data with CCDR-reported data for actual costs to date and estimated final cost. This should be accomplished for both data element and organization.

d. In those instances when reconciliations cannot be effected or when reasons for variances do not appear valid, the auditor should coordinate with the ACO and the government program monitor in recommending necessary procedural changes to ensure that subsequent valid reconciliations can be made.

11-207.1 Variance Analyses

The CPR provides for monthly disclosure of schedule and cost variances and contractor comments on significant problem areas, reasons for variances, their impact on the program, and corrective action taken or to be taken. The purpose of such variance analysis is to assess variances in terms of their contribution to cost growth and schedule slippage. The auditor's responsibilities on variances are to ensure that timely and responsible actions are taken to identify their causes and to minimize the impact of the variances on contract performance. Because of the effect of variances and contractor reactions thereto as they impact on planned downstream effort and projected estimates at completion, it is expected that considerable, frequent attention will be accorded this particular area in surveillance activities. Whereas the mechanical and procedural aspects of a C/SC

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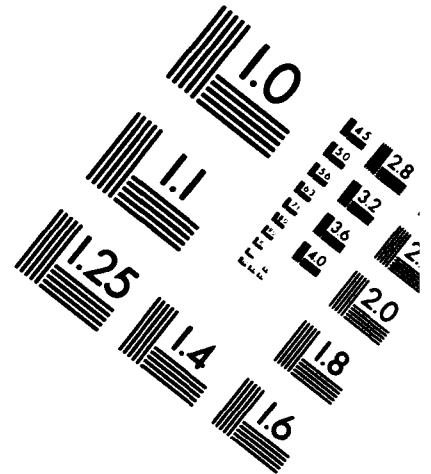
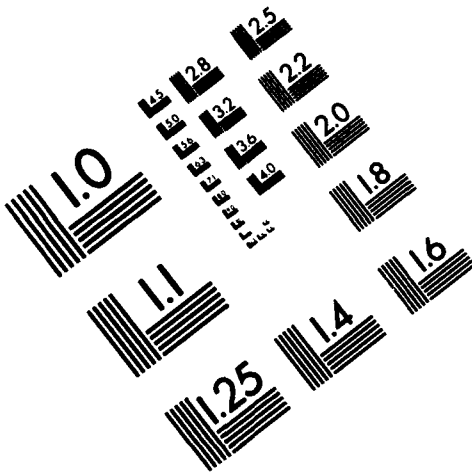


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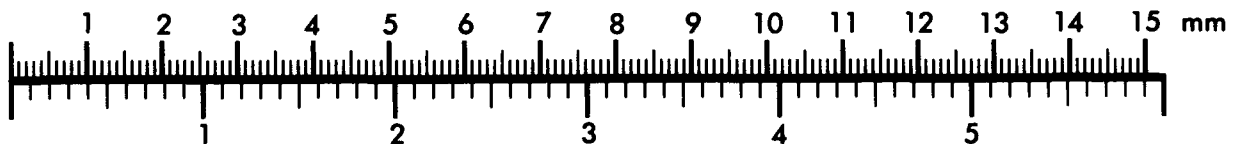
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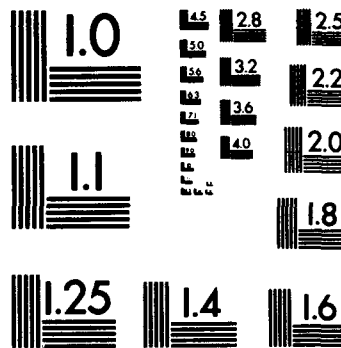
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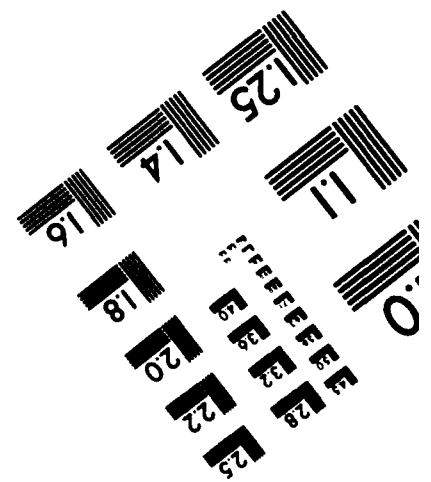
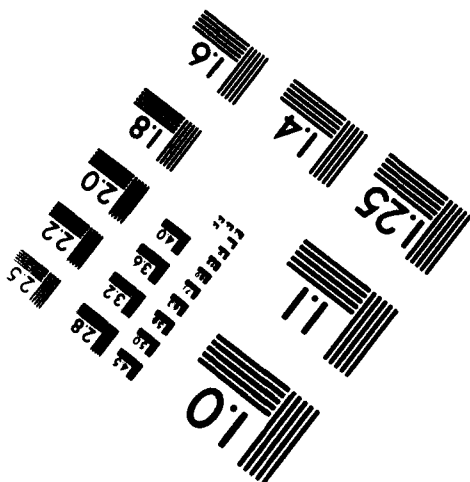
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system can be time-phased based on prior experience, each month's system activities, as reflected in the CPR, may indicate (1) potential or real new problems, (2) failure of the contractor to give prompt recognition to the effects of prior variances, or (3) that actions taken with respect to previously disclosed variances were not responsive to actual needs. Since schedule slippage and problems in technical performance also contribute to variances, the evaluation of variances and the contractor's proposed actions with respect thereto should be coordinated with the government program monitor and/or technical personnel. The following steps should be followed in evaluating variances:

- a. On a sampling basis, the auditor should select areas of significant cost variances as identified in the CPR and trace to the required action level.
- b. The auditor should determine if the narrative descriptions of the variances are valid and adequate.
- c. Causes and proposed remedies of the variances should be discussed with the contractor to determine if proposed actions will be responsive to the nature of the problem.
- d. The auditor should review estimated cost at contract completion to determine if the impact of any existing variances are reflected in the estimate to complete the contract.
- e. As necessary, the auditor should establish follow-up to the contractor's proposed action(s).

11-207.2 Estimate to Complete

- a. Detailed audit guidance for the review and evaluation of estimates for contract completion is in 14-205f. The frequency of reviews of the latest revised estimates to complete a contract will depend upon the adequacy of the contractor's procedures, including internal review procedures and the extent of contract changes which may, to some extent, give rise to revisions to the anticipated cost at completion. Because of the importance of estimated costs at completion, to both the contractor and the government, the auditor should perform a critical evaluation of the contractor's proposed amount. Coordination with technical

personnel is necessary to properly evaluate the estimate to complete.

- b. Contractors sometime report EACs to the government for billing and C/SCSC purposes which are different than those used for financial reporting purposes because of different risk assumptions and profit expectations. This is not a problem if the contractor can reconcile the differences. While it is necessary for auditors to compare EACs used by contractors for financial reporting purposes with those reported to the Government, the provisions of DoDI 5000.2 and the C/SCSC do not require a contractor to make such reconciliations and should not be used to gain access to financial statements. However, auditors should evaluate multiple EACs disclosed during C/SCSC audits. The contractor's inability to provide reconciliations may indicate performance to date and estimates of future conditions are not being accurately reflected in the contractor's EAC process which could be a C/S deficiency. Auditors should typically pursue access in these instances under billing system/progress payment audits.

11-207.3 Indirect Expenses

The Cost Performance Report (CPR) or other reporting mechanism generally provides for reporting of indirect expenses as a line item. The contractor will analyze significant variances between the planned and actual rates and, when unfavorable variances exist, the contractor will indicate the cause and corrective action to minimize the effect on cost performance. The auditor should be aware of rates used to establish the performance measurement baseline as related to the rates being reported, and also of any anticipated changes expected to occur which affect the value of planned effort, such as volume fluctuation, terminations, and revisions to the rate structure. Surveillance reports should indicate the actions taken by the contractor with respect to unfavorable variances and also data on expected changes which may create significant variances in subsequent periods.

11-208 Surveillance of Subcontractors

It is the prime contractor's responsibility to validate and maintain surveillance of subcontractor C/SC systems; however, there are unique situations when a subcontractor will be validated and/or surveillance will be performed by a DoD component rather than a prime contractor. This may occur when (1) the subcontractor, for competitive reasons, refuses access to records to a prime contractor; (2) the subcontractor is involved in several C/SCSC-required subcontracts issued by more than one prime contractor; or (3) the subcontractor may be functioning as a prime contractor on a validated C/SC system. In these instances, the cognizant auditor at the subcontractor location will perform the necessary system surveillance by the procedures described herein. When the prime contractor has retained surveillance responsibility, the audit plan at the prime contractor location should include the following steps:

a. The prime contractor's program for surveillance of the subcontractor's system should be reviewed to determine depth, scope, and overall adequacy.

b. The results of the prime contractor's surveillance efforts, including follow up, should be evaluated to ensure that indicated deficiencies are subsequently corrected.

c. The results of the prime contractor's evaluation of subcontractor-reported data, including action taken by the prime on significant variances reported by the subcontractor should be reviewed. The auditor should verify that estimates to complete the subcontract are revised to reflect the impact of significant variances.

d. The timeliness of subcontract reporting and subsequent incorporation of related data in the prime contractor's monthly report should be reviewed.

e. The auditor should report the need for necessary assist audits on areas not adequately evaluated by the prime contractor and on deficiencies disclosed by the prime contractor's surveillance activities which have gone uncorrected over an extended period of time. In this connec-

tion, auditors at subcontractor locations should advise auditors at prime contractor locations of any deficiencies noted during the functional reviews which may have an impact on the continued acceptability and validity of the subcontractor's system and related output. Routing of requests for assist audits and submission of audit reports will be accomplished through ACO channels.

11-209 Audit Working Papers and Reports**11-209.1 Reporting Results of Audit — Demonstration Reviews, ESARs, SARs, and Baseline Reviews**

a. When the audit work related to a demonstration review, ESAR, SAR, or baseline review is finished, the auditor will discuss the findings and recommendations with the audit supervisor and furnish them to the team chief in such form and detail as required for the C/SC systems criteria review team report. Any findings and recommendations will be provided to the team chief prior to completion of the in-plant effort of the C/SC systems criteria review team, to enable the team chief to conduct the exit conference with the contractor. The FAO will retain the detailed working papers covering DCAA's part of the review. Working papers supporting the auditor's conclusions regarding compliance or noncompliance with specific criteria will be documented in all instances and will include a record of the conclusions which have been furnished to the team chief. Reported deficiencies should be identified to specific criteria or the contractor's system description whenever possible. The auditor's report will be formally issued by the appropriate audit office as soon as possible after the C/SC systems criteria review team exit conference with the contractor. The team chief will also be provided with any summary schedules and/or copies of working papers required for consolidation of statistical data or as additional supporting documentation for the C/SC systems criteria review file.

b. Provide Headquarters, Attn: O, with a copy of each report which meets the following criteria:

(1) Recommends the disapproval of a previously accepted C/SC system.

(2) Discloses significant discrepancies in a contractor's C/SC system.

(3) Discloses significant restrictions on audit review caused by conditions such as denial of access to records.

**11-209.2 Reporting Results of Audit —
Surveillance Reviews**

a. Normally, the cognizant auditor will submit a formal report at the conclusion of surveillance reviews. The report should be prepared in accordance with 10-400 and provide clear statements of the scope of the review and any deficiencies noted, together with recommendations for their correction. Comments should also be provided regarding the results of discussions with the contractor's representative on deficiencies disclosed. To ensure that all pertinent data have been considered, the audit findings and recommendations will be discussed with the CAO C/SC monitor prior to issuance of the report. Systemic C/SC deficiencies should be highlighted in the report. Whenever possible, the auditor should relate any deficiencies to specific C/SC systems criteria. The report should be addressed to the principal cognizant ACO. A copy of the report will be provided directly to the C/SC monitor and the affected program office(s). A copy of each report meeting the criteria stated in 11-209.1 above will also be provided Headquarters, Attn: O.

b. There may be instances where issuance of a formal audit report will not be necessary. Bearing in mind that C/SC surveillance is an ongoing process, there will be sporadic contact between project office personnel, ACO/monitor, and the auditor on questions or situations requiring only minimal effort. Oral advice or memorandums may suffice in these instances. Working papers will be annotated to indicate what was accomplished. In the event that the impact of findings is significant, however, a formal report will be issued.

c. When applicable, surveillance reports should include a reference to reports issued on the results of functional reviews (see 14-500) that had an impact on or were affected by the C/SC system.

d. Deficiencies being reported in surveillance reports also need to be reported in proposal audit reports in an Appendix on Other Matters on proposals expected to result in contracts covered by DFARS clause 252.234-7001, Cost/Schedule Control Systems, or DFARS clause 252.242-7005, Cost/Schedule Status Report (10-307.5).

e. When deficiencies are disclosed while performing audits of material management and accounting systems (MMAS), labor, other accounting systems, forward pricing rates, budgets, and billing systems, the auditor will assess whether the deficiencies are likely to have a material effect on the reliability of the contractor's C/SC system and provide comments in the systems report. The auditor should immediately evaluate the impact of these deficiencies on the contractor's C/SC system data for specific contracts and where material provide the details in C/SC systems surveillance reports (10-407c). Periodic C/SC systems surveillance reviews (11-204) are still required.

f. Continued availability of information supporting earned values, incurred costs, and estimates to complete is necessary to perform proper surveillance of C/SC systems. In the event access to required contractor data is withheld or unduly restricted, follow the procedures in 1-500. When denial is continued, each surveillance report should include appropriate modification of the scope and opinion statements, with identification of the data being denied and its relationship to system surveillance requirements. If internal management budgets and forecast data are not made available during the surveillance review, the auditor should qualify the audit report and should recommend that the system validation be withdrawn. When applicable, the CAC should establish uniformity in necessary report qualifications to ensure consistency within corporate structures when more than one corporate segment is subject to C/SC system requirements.

**11-210 Cost/Schedule Control
(C/SC) Systems**

a. Many major government contracts contain clauses requiring an approved

C/SC system (11-200) for performance measurement on selected acquisitions. The regulations promulgating C/SC systems require that related program budgets be an integral part of the contractor's internal management system to enable the contractor to control costs properly. The adequacy and accuracy of C/SC system output are extremely important to the government.

b. Two major purposes of C/SC systems are to provide continuing visibility of final costs to the government and to quickly identify deviations from planned objectives in order to decide effectively on trade-offs between cost, schedule, and technical aspects. In this regard, estimated cost to complete is of vital concern and should reflect the best information available to the contractor. It is the government's responsibility in its surveillance of the C/SC system to determine that recorded costs are properly reported and to evaluate the reasonableness of estimated costs to complete.

c. To increase the reliance that can be placed on such estimates, the government should review master budgets and long-range plans (during contract duration), as well as the program budget. The government must know if the cost to complete, as indicated by the program budget, is reconcilable to master budgets and other information used by management to control company operations. Accordingly,

the auditor will perform the following steps.

(1) Determine that the program budgets required by C/SC systems are an integral part of the contractor's overall system for planning and controlling costs.

(2) Verify that the program budgets provide continuing visibility of interim and final costs to the government and that changes in plans are reflected promptly in new estimates to complete.

(3) Determine that the program budgets are used to identify significant deviations from planned objectives and quickly report these deviations to both contractor management and the government.

(4) During surveillance of C/SC systems, determine whether the recorded costs and the estimated cost to complete are reconcilable to master budgets and other information used by management to control company operations. This is particularly important for indirect cost projections because variance analysis of the operating budget is one of the techniques management should use to control indirect costs.

d. The impact of conditions disclosed during C/SC system audits should be considered when planning and performing other audits. For example, deficiencies in estimating costs at completion may significantly affect contractor forward pricing proposals and billing requests.

11-2S1 Supplement — DoD Instruction 5000.2 Part 11, Section B — Contract Performance Measurement

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PART 11 SECTION B CONTRACT PERFORMANCE MEASUREMENT

References:

(a) DoD Instruction 7000.2, "Performance Measurement for Selected Acquisitions," June 10, 1977 (canceled)

(b) DoD 5000.2-M, "Defense Acquisition Management Documentation and

Reports," February 1991, authorized by this Instruction

(c) Cost/Schedule Control Systems Criteria Joint Implementation Guide (AFSCP 173-5, AFCCP 173-5, AMC-P 715-5, NAVSOP 3627, DLA H 8400.2, DCAA P 7641.47), October 1, 1987

(d) Cost/Schedule Control Systems Criteria Joint Surveillance Guide (AFSCP 173-6, AFLCP 173-6, AMC-P 715-10, NAVMAT P 5243, DSA H 8315.1, DCAA P 7641.46), July 1, 1974

(e) Defense Federal Acquisition Regulation Supplement (DFARS), Subpart 234.005-70, "Contract Clauses for Major Systems Acquisition," and Contract Clause 252.234-7001, "Cost/Schedule Control Systems"

(f) Federal Acquisition Regulation (FAR), Subpart 31.202, "Direct Costs," and Subpart 31.203, "Indirect Costs," current edition

1. PURPOSE

a. This section replaces DoD Instruction 7000.2, "Performance Measurement for Selected Acquisitions" (reference (a)), which has been canceled.

b. These policies and procedures establish the basis for applying cost/schedule control systems criteria (C/SCSC) to significant defense contracts.

c. The purpose of cost/schedule control systems criteria is to provide contractor and the Government program managers with accurate data to monitor execution of their program and to:

(1) Preclude the imposition of specific cost and schedule management control systems by providing uniform evaluation criteria to ensure contractor cost and schedule management control systems are adequate;

(2) Provide an adequate basis for responsible disentiing by both contractor management and DoD Component personnel by requiring that contractors' internal management control systems produce data that:

(a) Indicate work progress;
(b) Properly relate cost, schedule, and technical accomplishment;
(c) Are valid, timely, and able to be audited; and

(d) Provide DoD Component managers with information at a practical level of summarization; and

(3) Bring to the attention of DoD contractors, and encourage them to accept and install, management control systems and procedures that are most

effective in meeting requirements and controlling contract performance.

2. POLICIES

a. When applicable, the contract shall require that any system used by the contractor in planning and controlling the performance of the contract shall meet the criteria set forth in this section.

(1) Nothing in these criteria is intended to affect the basis on which costs are reimbursed and progress payments made, and nothing herein shall be construed as requiring the use of any single system, or specific method of management control or evaluation of performance.

(2) The contractor's internal systems need not be changed, provided they satisfy these criteria.

(3) The contractors' management control systems shall include policies, procedures, and methods which are designed to ensure that they shall accomplish the considerations highlighted in attachment 1.

b. Unless waived by the milestone decision authority or a designated representative, compliance with the cost/schedule control systems criteria shall be required on significant contracts and subcontracts within all acquisition programs, including highly sensitive classified programs and major construction programs.

(1) This also includes significant contracts executed for foreign governments and for specialized organizations such as the Defense Advanced Research Projects Agency, and significant acquisition effort performed by Government activities.

(2) Significant contracts are research, development, test, and evaluation contracts with a value of \$60 million or more or procurement contracts with a value of \$250 million or more (in fiscal year 1990 constant dollars).

c. Compliance with the cost/schedule control systems criteria shall not be required on firm fixed price contracts (including firm fixed price contracts with economic price adjustment provisions), time and materials contracts, and contracts which consist mostly of level-of-effort work. Exceptions may be made by

the milestone decision authority for individual contracts.

d. On contracts that are determined to be not significant enough for cost/schedule control systems criteria application, the cost/schedule status report (C/SSR) shall be required unless excluded under paragraph 2.c., above. The cost/schedule status report is described in DoD 5000.2-M, "Defense Acquisition Management Documentation and Reports" (reference (b)).

3. PROCEDURES

a. *General.* Cost and schedule performance data provided to the Government will be summarized directly from the same systems used for internal contractor management.

(1) The policies and procedures contained herein will not be construed as requiring the use of specific systems or changes in accounting systems which will adversely affect the equitable distribution of costs to all contracts, or compliance with cost accounting standards, rules, and regulations.

(2) No changes will be required in contractors' existing cost and schedule control systems except those changes minimally necessary to meet the cost/schedule control systems criteria.

b. *Subcontracts.* Subcontracts within applicable programs, excluding those that are firm fixed price, may be selected for application of cost/schedule control systems criteria by mutual agreement between prime contractor and the contracting DoD Component, according to the criticality of the subcontract to the program.

(1) Coverage of certain critical subcontracts may be directed by the Program Manager, subject to the changes clause of the contracts.

(2) In those cases where a subcontractor is not required to comply with the criteria, the cost/schedule status report approach to performance measurement will normally be used. (See DoD 5000.2-M, "Defense Acquisition Management Documentation and Reports" (reference (b)).)

c. *Milestone Decision Review.* The applicability of cost/schedule control sys-

tems criteria and provisions concerning the acceptability and use of contractor's cost/schedule control systems will be:

(1) Included in the Integrated Program Summary (IPS) developed in support of a Milestone II or Milestone III decision review (see Section 11-C);

(2) Addressed in acquisition plans; and

(3) Set forth in solicitations and made a contractual requirement in appropriate procurements (see Subparts 234.005-71 and 252.234-7001 of the Defense Federal Acquisition Regulation Supplement (reference (e))).

d. *Reviews of Systems.* To ensure compliance with cost/schedule control systems criteria, contractors' systems will be reviewed during various phases of the contracting process as follows:

(1) Where the cost/schedule control systems criteria are included as a requirement in the request for proposal, an evaluation review will be performed as an integral part of the source selection process.

(2) After contract award, an in-plant demonstration review will be made to verify that the contractor is operating systems that meet the criteria.

(3) Upon successful completion of the demonstration review, contractors will not be subjected to another demonstration review unless there are positive indications that the contractors' systems no longer operate so as to meet the criteria.

(4) Subsequent contracts may require a review of shorter duration and less depth to ensure proper and effective application of the accepted systems to the new contract.

(5) Detailed procedures relating to contractual application, interpretive guidance, inter-Service relationships, and conduct of systems reviews are in the Cost/Schedule Control Systems Criteria Joint Implementation Guide (reference (c)).

e. *Advance Agreement.* After determination that a management system meets the cost/schedule control systems criteria, an advance agreement may be established between the Department of Defense and the contractor to be incorporated by reference into future contracts.

(1) The use of the advance agreement contemplates the execution of a written instrument that references the cost/schedule control systems criteria and negotiated provisions, which:

(a) Reflect an understanding between the contractor and the DoD of the cost/schedule control systems criteria requirements.

(b) Identify the specific cost/schedule control systems criteria compliant system(s) that the contractor intends to use on applicable contracts with DoD Components.

(2) The advance agreement will include or reference a written description of the accepted system(s).

(a) The system description should be in sufficient detail to permit adequate surveillance by responsible parties.

(b) The use of the advance agreement is preferred where a number of separate contracts between one or more DoD Components and the contractor may be entered into during the term of the advance agreement.

(c) The DoD Component negotiating the advance agreement with the contractor will make the agreement for all prospective contracting DoD Components.

(3) Action to develop an advance agreement may be started by either contractor or the DoD Component, normally in connection with a contractual requirement.

(a) Reference to an advance agreement satisfies the cost/schedule control systems criteria requirement in requests for proposal.

(b) Procedures for executing advance agreements are included in the Cost/Schedule Control Systems Criteria Joint Implementation Guide (reference (c)).

f. *Surveillance.* Recurring evaluations of the effectiveness of the contractor's policies and procedures will be performed to ensure that the contractor's

system continues to meet the cost/schedule control systems criteria and provides valid data consistent with the intent of this section.

(1) Surveillance reviews will be based on selective tests of reported data and periodic evaluations of internal practices during the life of the contract.

(2) Guidance for surveillance is contained in the Cost/Schedule Control Systems Criteria Joint Surveillance Guide (reference (d)).

4. RESPONSIBILITIES AND POINTS OF CONTACT

a. Each DoD Component will designate a component performance measurement cost/schedule control systems criteria focal point.

(1) The Component focal points will constitute the Performance Measurement Joint Executive Group (PMJEG).

(2) The Performance Measurement Joint Executive Group will provide uniform joint policy and procedure recommendations for DoD Component Head approval.

(3) The Performance Measurement Joint Executive Group will provide uniform cost/schedule control systems criteria interpretation, arbitration, and coordination with industry.

b. The Defense Contract Audit Agency and applicable contract administration offices will participate in reviews of contractors' systems under their cognizance, perform surveillance, and collaborate with each other and with the procuring DoD Component in reviewing areas of joint interest.

c. The matrix below identifies the offices to be contacted for additional information on this section. The full titles of these offices may be found in Part 14 of this Instruction.

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DoD Component	Points of Contact	
	General	Specific
OSD	Dir, AP&PI	DepDir, CM SARD-
Dept of Army	ASA(RDA)	ZP
Dept of Navy	ASN(RDA)	Dir, APIA
Dept of Air Force	ASAF(FM)	SAF/ FMC

PART 11
SECTION B
ATTACHMENT 1 COST/SCHEDULE CONTROL SYSTEMS
CRITERIA

The contractors' management control systems shall include policies, procedures and methods that are designed to ensure that they will accomplish the considerations reflected herein.

1. Organization

a. Define all authorized work and related resources to meet the requirements of the contract, using the contract work breakdown structure (WBS).

b. Identify the internal organizational elements and the major subcontractors responsible for accomplishing the authorized work.

c. Provide for the integration of the contractor's planning, scheduling, budgeting, work authorization and cost accumulation systems with each other, the contract work breakdown structure, and the organizational structure.

d. Identify the managerial positions responsible for controlling overhead (indirect costs).

e. Provide for integration of the contract work breakdown structure with the contractor's functional organizational structure in a manner that permits cost and schedule performance measurement for contract work breakdown structure and organizational elements.

2. Planning and Budgeting

a. Schedule the authorized work in a manner which describes the sequence of work and identifies the significant task interdependencies required to meet the development, production, and delivery requirements of the contract.

b. Identify physical products, milestones, technical performance goals, or other indicators that will be used to measure output.

c. Establish and maintain a time-phased budget baseline at the cost account level against which contract performance can be measured. Initial budgets established for this purpose will be based

on the negotiated target cost. Any other amount used for performance measurement purposes must be formally recognized by both the contractor and the Government.

d. Establish budgets for all authorized work with separate identification of cost elements (labor, material, etc.).

e. To the extent the authorized work can be identified in discrete, short span work packages, establish budgets for this work in terms of dollars, hours, or other measurable units. Where the entire cost account can not be subdivided into detailed work packages, identify far term effort in larger planning packages for budget and scheduling purposes.

f. Provide that the sum of all work package budgets, plus planning package budgets within a cost account equals the cost account budget.

g. Identify relationships of budgets or standards in work authorization systems to budgets for work packages.

h. Identify and control level-of-effort activity by time-phased budgets established for this purpose. Only that effort which cannot be identified as discrete, short span work packages or as apportioned effort may be classed as level-of-effort.

i. Establish overhead budgets for the total costs of each significant organizational component whose expenses will become indirect costs. Reflect in the contract budgets at the appropriate level the amounts in overhead pools that are planned to be allocated to the contract as indirect costs.

j. Identify management reserves and undistributed budget.

k. Provide that the contract target cost plus the estimated cost of authorized but unpriced work is reconciled with the sum of all internal contract budgets and management reserves.

3. Accounting

a. Record direct costs on an applied or other acceptable basis in a manner con-

sistent with the budgets in a formal system that is controlled by the general books of account.

b. Summarize direct costs from cost accounts into the work breakdown structure without allocation of a single cost account to two or more work breakdown structure elements.

c. Summarize direct costs from the cost accounts into the contractor's functional organizational elements without allocation of a single cost account to two or more organizational elements.

d. Record all indirect costs which will be allocated to the contract.

e. Identify the bases for allocating the cost of apportioned effort.

f. Identify unit costs, equivalent unit costs, or lot costs as applicable.

g. The contractor's material accounting system will provide for:

(1) Accurate cost accumulation and assignment of costs to cost accounts in a manner consistent with the budgets using recognized, acceptable costing techniques.

(2) Determination of price variances by comparing planned versus actual commitments.

(3) Cost performance measurement at the point in time most suitable for the category of material involved, but no earlier than the time of actual receipt of material.

(4) Determination of cost variances attributable to the excess usage of material.

(5) Determination of unit or lot costs when applicable.

(6) Full accountability for all material purchased for the contract, including the residual inventory.

4. Analysis

a. Identify at the cost account level on a monthly basis using data from, or reconcilable with, the accounting system:

(1) Comparison of budgeted cost for work scheduled and budgeted cost of work performed;

(2) comparison of budgeted cost for work performed and actual (applied where appropriate) direct costs for the same work; and

(3) Variances resulting from the comparisons between the budgeted cost for work scheduled and the budgeted cost for work performed and between the budgeted cost for work performed and actual or applied direct costs, classified in terms of labor, material, or other appropriate elements together with the reasons for significant variances.

b. Identify on a monthly basis, in the detail needed by management for effective control, budgeted indirect costs, actual indirect costs, and cost variances with the reasons for significant variances.

c. Summarize the data elements and associated variances listed in subparagraphs 4.a.(1) and (2), above, through the contractor organization and work breakdown structure to the reporting level specified in the contract.

d. Identify significant differences on a monthly basis between planned and actual schedule accomplishment and the reasons.

e. Identify managerial actions taken as a result of criteria items in paragraphs 4.a. through 4.d., above.

f. Based on performance to date, on commitment values for material, and on estimates of future conditions, develop revised estimates of cost at completion for work breakdown structure elements identified in the contract and compare these with the contract budget base and the latest statement of funds requirements reported to the Government.

5. Revisions and Access to Data

a. Incorporate contractual changes expeditiously, recording the effects of such changes in budgets and schedules. In the directed effort prior to negotiation of a change, base such revisions on the amount estimated and budgeted to the functional organizations.

b. Reconcile original budgets for those elements of the work breakdown structure identified as priced line items in the contract, and for those elements at the lowest level in the program work breakdown structure, with current performance measurement budgets in terms of changes to the authorized work and internal replanning in the detail needed by management for effective control.

c. Prohibit retroactive changes to records pertaining to work performed that would change previously reported amounts for direct costs, indirect costs, or budgets, except for correction of errors and routine accounting adjustments.

d. Prevent revisions to the contract budget base except for Government directed changes to contractual effort.

e. Document internally the changes to the performance measurement baseline and notify expeditiously the procuring activity through prescribed procedures.

f. Provide the Contracting Officer and the Contracting Officer's authorized representatives with access to the information and supporting documentation necessary to demonstrate compliance with the cost/schedule control systems criteria.

PART 11

SECTION B

ATTACHMENT 2 COST/SCHEDULE CONTROL SYSTEMS CRITERIA DEFINITIONS

1. Actual Cost of Work Performed (ACWP). The costs incurred and recorded in accomplishing the work performed within a given time period.

2. Actual Direct Costs. Those costs identified specifically with a contract, based upon the contractor's cost identification and accumulation system as accepted by the cognizant Defense Contract Audit Agency representatives. (See definition 14 below.)

3. Allocated Budget. (See definition 32 below.)

4. Applied Direct Costs. The amounts recognized in the time period associated with the consumption of labor, material, and other direct resources, without regard to the date of commitment or the date of payment. These amounts are to be charged to work-in-process in the time period that any one of the following takes place:

a. When labor, material, and other direct resources are actually consumed.

b. When material resources are withdrawn from inventory for use.

c. When material resources are received that are identified uniquely to the contract and scheduled for use within 60 days.

d. When major components or assemblies are received on a line flow basis that are identified specifically and uniquely to a single serially numbered end item.

5. Apportioned Effort. Effort that is not readily divisible into work packages, but is related proportionately to measured effort.

6. Authorized Work. Effort which has been definitized and is on contract, plus that for which definitized contract costs have not been agreed to, but for which written authorization has been received.

7. Baseline. (See definition 24 below.)

8. Budgeted Cost for Work Performed (BCWP). The sum of the budgets for completed work packages and completed portions of open work packages, plus the applicable portion of the budgets for level-of-effort and apportioned effort.

9. Budgeted Cost for Work Scheduled (BCWS). The sum of budgets for all work packages, planning packages, etc., scheduled to be accomplished (including in-process work packages), plus the amount of level-of-effort and apportioned effort scheduled to be accomplished within a given time period.

10. Budgets for Work Packages. (See definition 36 below.)

11. Contract Budget Base. The negotiated contract cost plus the estimated cost of authorized unpriced work.

12. Contractor. An entity in private industry which enters into contracts with the Government. In this Instruction, the word may also apply to Government-owned, Government-operated activities which perform work on major defense programs.

13. Cost Account. A management control point at which actual costs may be accumulated and compared to the budgeted costs of the work performed. A cost account is a natural control point for cost/schedule planning and control, since

it represents the work assigned to one responsible organizational element on one contract work breakdown structure element.

14. Direct Costs. Any costs which can be identified specifically with a particular final cost objective. This term is explained in Federal Acquisition (reference (f)).

15. Estimate at Completion (EAC). Actual direct costs, plus indirect costs allocable to the contract, plus the estimate of costs (direct and indirect) for authorized work remaining.

16. Indirect Costs. Costs, which because of their incurrence for common or joint objectives, are not subject readily to treatment as direct costs. This term is further defined in Federal Acquisition (reference (f)).

17. Initial Budget. (See definition 22 below.)

18. Internal Replanning. Replanning actions performed by the contractor for remaining effort within the recognized total allocated budget.

19. Level-of-Effort (LOE). Effort of a general or supportive nature that does not produce definite end products.

20. Management Reserve or Management Reserve Budget. An amount of the total allocated budget withheld for management control purposes, rather than designated for the accomplishment of a specific task or set of tasks. It is not a part of the performance measurement baseline.

21. Negotiated Contract Cost. The estimated cost negotiated in a cost plus fixed fee contract, or the negotiated contract target cost in either a fixed price incentive contract or a cost plus incentive fee contract.

22. Original Budget. The budget established at, or near, the time the contract was signed based on the negotiated contract cost.

23. Overhead. (See definition 16 above.)

24. Performance Measurement Baseline. The time phased budget plan against which contract performance is measured. It is formed by the budgets assigned to scheduled cost accounts and the applicable indirect budgets. For future effort, not planned to the cost account level, the

performance measurement baseline also includes budgets assigned to higher level contract work breakdown structure elements and undistributed budgets. It equals the total allocated budget less management reserve.

25. Performing Organization. A defined unit within the contractor's organization structure, which applies the resources to perform the work.

26. Planning Package. A logical aggregation of far term work within a cost account which may be identified and budgeted in early baseline planning, but is not yet defined into work packages.

27. Procuring Activity. The subordinate command in which the Procurement Contracting Officer is located. It may include the program office, related functional support offices, and procurement offices. Examples of procuring activities are Army Missile Command, Naval Sea Systems Command, and Air Force Electronic Systems Division.

28. Replanning. (See definition 18 above.)

29. Reprogramming. Replanning of the effort remaining in the contract, resulting in a new budget allocation which exceeds the contract budget base.

30. Responsible Organization. A defined unit within the contractor's organizational structure that is assigned responsibility for accomplishing specific tasks.

31. Significant Variances. Those differences between planned and actual performance requiring further review, analysis, or action. Thresholds should be established as to the magnitude of variances which will require variance analysis, and the thresholds should be revised as needed to provide meaningful analysis during execution of the contract.

32. Total Allocated Budget. The sum of all budgets allocated to the contract. Total allocated budget consists of the performance measurement baseline and all management reserve. The total allocated budget will reconcile directly to the contract budget base. Any differences will be documented as to quantity and cause.

33. Undistributed Budget. Budget applicable to contract effort which has not yet been identified to contract work breakdown structure elements at, or be-

low, the lowest level of reporting to the Government.

34. Variances. (See definition 31, above.)

35. Work Breakdown Structure (WBS). (See Section 6-B.)

36. Work Package Budgets. Resources which are formally assigned by the contractor to accomplish a work package, expressed in dollars, hours, standards, or other definitive units.

37. Work Packages. Detailed tasks or material items identified by the contractor for accomplishing work required to complete the contract. A work package has the following characteristics:

a. It represents units of work at levels where work is performed.

b. It is clearly distinguishable from all other work packages.

c. It is assignable to a single organizational element.

d. It has scheduled start and completion dates and, as applicable, interim milestones; all of which are representative of physical accomplishment.

e. It has a budget or assigned value expressed in terms of dollars, manhours, or other measurable units.

f. Its duration is limited to a relatively short span of time or it is subdivided by discrete value milestones to ease the objective measurement of work performed.

g. It is integrated with detailed engineering, manufacturing, or other schedules.

11-300 Section 3 — Review of Contractor Compliance with DoD Program Management Systems Reporting Requirements

11-301 Introduction

This section provides audit procedures and guidance for reviewing contractor management control systems, and the related cost reports, which implement the requirements of DoD Instruction 5000.2, "Defense Acquisition Management Policies and Procedures." Audit effort required for the review of the various contractor responsibilities under the Instruction should be integrated with other system and functional reviews (such as audit of incurred costs, evaluation of proposals, and estimating system surveys, etc.).

11-302 Background

a. Over an extended period of time, the Office of the Secretary of Defense and the military departments have developed a variety of management systems for use in the acquisition process. These systems provide the government with a capability to obtain timely and valid cost, funding, schedule, and related management information for use in contract performance analysis and program control. In February 1991, DoD Instruction 5000.2, "Defense Acquisition Management Policies and Procedures" consolidated all previous DoD acquisition management policies and procedures into a single Instruction. DoD policies and procedures related to Cost/Schedule Control System Criteria (C/SCSC) and DoD contract cost management reporting requirements are now contained in DoDI 5000.2, Part 11, Section B, "Contract Performance Measurement" (replaced DoDI 7000.2) and DoD Manual 5000.2-M, Part 20, "Cost Management Reports" (replaced DoDIs 7000.10 and 7000.11). Audit guidance relative to C/SCSC is discussed in CAM 11-200. DCAA audit effort under DoDI 5000.2 primarily involves the review of contractor financial records to validate the accuracy and propriety of reported data.

b. The various standard cost management reports required by DoD Instruc-

tion 5000.2, Part 11, Section B, are prescribed in DoD Manual 5000.2-M, Part 20, "Cost Management Reports." These reports are (1) Contractor Cost Data Reports (CCDRs), (2) Cost Performance Reports (CPRs), (3) Cost/Schedule Status Reports (C/SSRs), and (4) Contract Funds Status Reports (CFSRs). Audit guidance pertaining to these cost management reports is discussed in the ensuing paragraphs.

11-303 Contract Funds Status Report (CFSR)

11-303.1 Introduction

The objective of the CFSR is to provide information about contract funding requirements for specifically designated programs to assist the system manager in (1) updating and forecasting contract fund requirements, (2) planning and decision making on changes in the fund requirements, (3) developing fund requirements and budget estimates in support of approved programs, and (4) determining funds in excess of contract needs and available for de-obligation.

11-303.2 Application

a. The CFSR, DD Form 1586, is used to obtain funding data on contracts over 6 months in duration. No specific application thresholds are established; however, application to contracts of less than \$1 million (constant year 1990 dollars) is evaluated carefully to ensure that only the minimum information necessary for effective management control is required. It may be implemented at a reduced level of reporting for contracts with a dollar value between \$250,000 and \$1,000,000. Firm-fixed-price contracts are excluded from CFSR coverage unless unusual circumstances require specific funding visibility. CFSR may be applied to unpriced portions of firm-fixed-price contracts that individually or collectively are estimated by the government to be in excess of 20 percent of the initial contract value. The reports are prepared quarterly under normal circumstances and are sub-

¶11-303.2a.

mitted within 25 calendar days after the cut-off date or the number of days specified in the contract. Under unusual circumstances monthly reporting may be required.

b. In view of the comparatively low dollar threshold of contracts under which CFSR reports are required, the guidance furnished in 11-303.4 and 11-303.5, below, must be judiciously applied in order to avoid extensive audit involvement under comparatively small dollar value contracts.

11-303.3 Interrelationship with CAS

Cost Accounting Standard 401, "Consistency in Estimating, Accumulating and Reporting Costs," was established to (1) assure that cost accounting practices used by a contractor in estimating costs for proposals are consistent with those practices used in accumulating and reporting costs during contract performance and (2) provide a basis for comparing such costs. The auditor should ensure that data in budget and management reports required by the contract meet CAS 401 requirements (8-401).

11-303.4 Audit Objectives and Procedures

a. The CFSR report is an integral part of DoD's contract performance measurement system and the data reported is used for high-level management purposes; accordingly, CFSR submissions should be carefully and periodically reviewed.

b. The review of a contract and the briefing of its provisions (see 3-200) will disclose whether the contract incorporates CFSR reporting requirements.

c. When specifically requested by the contracting officer, a survey will be performed prior to the award of a contract under which CFSR requirements are contemplated. The preaward survey will include a review to determine if the contractor's accounting system and procedures are adequate and reliable for CFSR purposes, and will also consider the contractor's procedures for accumulating and reporting total cumulative expenditures and for estimating contract completion costs. Reviews of individual CFSR

submissions will also be made at the specific request of the contracting officer.

d. Selective reviews will be performed periodically to determine if satisfactory policies and procedures are being used in developing CFSR and other reported data and whether reported information is reliable. The frequency of such reviews will be a matter of judgment based upon the results of the preaward survey and/or the auditor's experience with the reliability of CFSR data. However, review of the adequacy of a contractor's CFSR data accumulation procedures, and the propriety of related reporting, shall be accomplished at least once a year at those contractor locations where the prices of CFSR-covered contracts aggregate \$50 million or more unless the requirement is waived by the regional audit manager.

e. The information in CFSRs should also be compared with like data which may have been presented by the contractor in other financial management reports for comparable periods, such as the C/SSRs and CPRs, to determine if they agree or are reconcilable. Inconsistencies or differences among reported data not adequately explained should be brought to the attention of the contracting officer.

f. The auditor should follow the guidance in 11-100 relative to "Limitation of Cost" and "Limitation on Payments" contract clauses, as appropriate. When it becomes evident that a loss is anticipated for a fixed-price contract, the auditor will ascertain whether the contractor is entitled to progress payments. If so, the auditor should make sure that the indicated rate of loss disclosed in the CFSR review is applied as a reduction to any costs submitted by the contractor for purposes of computing its progress payment entitlement.

g. Review of CFSR submissions will include evaluation of contractor compliance with the reporting due date provided for in the contract or as otherwise agreed to between the contractor and the contracting officer. Deficiencies in meeting required submission dates will be discussed with the contractor. Continued failure to meet submission dates should be reported in writing to the contracting officer together with recommendations required to correct the deficiencies. A

copy of the report will be forwarded to Headquarters, Attn: O.

h. The results of reviews of the operations of major contractors made in accordance with 14-500 should also be considered in determining the scope of audit.

11-303.5 Reporting Results of Audit

a. An audit report will be prepared (1) on each preaward survey requested by the contracting officer, (2) in response to the request of the contracting officer for reviews of individual CFSRs, (3) on each review of CFSR data accumulation and reporting procedures when significant deficiencies are disclosed, and (4) whenever a procedural deficiency or major accounting change has a significant adverse effect on the accuracy of submitted CFSR data.

b. The preaward survey report should be prepared in accordance with 5-200. It will include the auditor's opinion on the adequacy of the contractor's accounting system and procedures to generate the type of data required by the CFSR.

c. Audit reports will (1) indicate the impact of deficiencies on the accuracy of the reported data, (2) recommend corrective action to be taken by the contractor, (3) state the contractor's reaction to the recommendation and any corrective action planned or initiated, and (4) include the status of any previously reported deficiencies which the contractor has not satisfactorily corrected. To ensure that all pertinent data have been considered, the audit findings and recommendations will be discussed with the ACO prior to issuance of the report.

d. Audit reports will be addressed to the activity requesting the review with a copy to the ACO. Reports resulting from reviews initiated by the auditor will be addressed to the ACO. The guidance provided in 10-1200 should be followed in the preparation of reports resulting from CFSR reviews.

11-304 Cost Performance Report (CPR)

11-304.1 Introduction

The objective of the CPR is to provide data to government system managers

which may be used by them to (1) evaluate contract performance, (2) identify actual and potential problem areas having significant cost impact, and (3) respond to requests for program status information on major weapon/support system acquisitions. To permit this type of management control, the CPR requires, among other things, (1) information on cost and schedule performance by work breakdown structure and functional cost categories, (2) actual manpower utilization versus the budgeted plan, and (3) narrative comments explaining major cost and schedule variances, as well as an identification of significant problems and action contemplated for their resolution.

11-304.2 Application

a. The CPR is required on all contracts which require compliance with the Cost/Schedule Control Systems Criteria (C/SCSC) of DoDI 5000.2, Part 11, Section B. CPRs are not required on firm fixed-price contracts unless unusual circumstances require cost and schedule visibility. However, it may be required on flexibly priced contracts, not subject to C/SCSC, when the DoD component requires more data than available on the C/SSR.

b. In those instances where the CPR supports a contractual requirement for contractor compliance with C/SCSC, the CPR data elements will reflect the contractor's implementation of DoDI 5000.2. If compliance with the C/SCSC is not contractually required, the data elements to be reported on the CPR will be as specified in the solicitation document or as subsequently negotiated.

c. The CPR will be submitted monthly unless otherwise provided for in the contract. Military department reports used to collect similar cost and schedule performance information from contractors are to be superseded when the CPR is made a contractual requirement.

11-304.3 Audit Objectives and Procedures

a. Because the CPR is an integral part of DoD's contract performance measurement system and the data reported is used for high-level management purposes, it is necessary that CPR submis-

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sions be carefully and periodically reviewed by the auditor.

b. The review of a contract and the briefing of its provisions (see 3-200) will disclose whether the contract incorporates CPR reporting requirements. If so, the auditor will evaluate the adequacy and effectiveness of the policies and procedures established by the contractor for developing and reporting actual and projected costs.

c. The auditor will establish controls to assure the receipt of all CPR submissions.

d. A review will be made of the contractor's initial CPR submission under each contract. Reviews of subsequent CPR submissions will also be made at the request of the contracting officer and as provided in e. below.

e. Audit evaluation of the contractor's policies and procedures providing for the accumulation of data and CPR preparation shall be performed at least once a year. Various CPRs submitted under each of the contractor's eligible contracts shall be selectively tested during this evaluation, to assure the accuracy and propriety of report data. Audit reviews will be made more frequently if the initial and/or subsequent reviews disclose significant deficiencies; the frequency of such reviews will depend upon the circumstances involved. The audit evaluation should consider the requirements of CAS 401. (See 8-401 with regard to consistency in reporting costs.)

f. Data reported in the CPRs should be compared with like information which may have been presented by the contractor in other financial management reports for comparable periods, such as the CFSRs and CCDRs, to determine if they agree or are reconcilable.

g. The CPR review will include an evaluation of contractor compliance with the reporting due date provided for in the contract or as otherwise agreed to between the contractor and the contracting officer. Deficiencies in meeting dates will be discussed with the contractor. Continued failure to meet submission dates should be reported in writing to the contracting officer together with recommendations required to correct the defi-

ciencies. A copy of the report will be forwarded to Headquarters, Attn: O.

11-304.4 Reporting Results of Audit

a. An audit report will be prepared using the format contained in 10-1200, on the contractor's initial CPR submission for each contract. It will state the auditor's opinion on the adequacy of the contractor's CPR policies, procedures, and internal controls and the accuracy of the reported cost data. An audit report will also be prepared in response to specific requests for audit by the contracting officer.

b. If subsequent reviews of the contractor's CPR procedures made according to 11-304.3e. above disclose significant deficiencies, or the auditor is unable to reconcile specific data with like information on CFSRs or other management system reports for comparable periods, the audit reports will (1) indicate the impact of the deficiencies on the accuracy of the reported cost data, (2) specify the reports to which the deficiencies pertain, (3) recommend corrective action to be taken by the contractor, and (4) state the contractor's reaction to the recommendations and any corrective action planned or initiated. Audit reports will include the status of any previously reported deficiencies which have not been satisfactorily corrected. To ensure that all pertinent data have been considered, the audit findings and recommendations will be discussed with the ACO prior to issuance of the report.

c. All audit reports will be submitted to the contract administration office. When significant deficiencies are disclosed, a copy of the report will be forwarded to Headquarters, Attn: O.

d. It is not expected that the contracting officer will request an audit of each CPR submission; however, at those contractor locations where serious deficiencies continue, it may be necessary to issue periodic audit reports indicating contractor progress in correcting such deficiencies.

11-305 Cost/Schedule Status Report (C/SSR)**11-305.1 Introduction**

The objective of the C/SSR is to provide summarized cost and schedule per-

formance status information on contracts over 12 months in duration when application of the Cost Performance Report (CPR) is not appropriate. The C/SSR requires (1) information on cost schedule performance by work breakdown structure and (2) narrative comments explaining major cost and schedule variances, as well as an identification of significant problems and action contemplated for their resolution.

11-305.2 Application

a. No specific application thresholds are established; however, application to contracts of less than \$5 million (constant year 1990 dollars) is evaluated carefully to ensure that only the minimum information necessary for effective management control is required. C/SSR is not required on firm fixed-price contracts unless unusual circumstances require cost and schedule visibility. C/SSR is established as a contractual requirement as set forth in the Contract Data Requirements List, DD Form 1423, and Management System Summary List, DD Form 1660.

b. The C/SSR will be submitted in accordance with the terms specified in the contract but is not required more frequently than monthly.

11-305.3 Audit Objectives and Procedures

The audit objectives and procedures in 11-304.3 also apply to C/SSR.

11-305.4 Reporting Results of Audit

a. Audit reports pertaining to a contractor's initial submission will be prepared in accordance with the format in 10-1200. The report will state the auditor's opinion on the adequacy of the contractor's C/SSR policies, procedures, and internal controls and the accuracy of the reported cost data. Audit reports will also be prepared only in response to specific requests for review by the contracting officer, or when deficiencies are disclosed during DCAA-initiated reviews.

b. If subsequent reviews of the contractor's C/SSR procedures disclose significant deficiencies, or the auditor is unable to reconcile specific data with like infor-

mation on CFSRs or other management system reports for comparable periods, the audit reports will (1) indicate the impact of the deficiencies on the accuracy of the reported cost data, (2) specify the reports to which the deficiencies pertain, (3) recommend corrective action to be taken by the contractor, and (4) state the contractor's reaction to the recommendations and any corrective action planned or initiated. Audit reports will include the status of any previously reported deficiencies which have not been satisfactorily corrected. To ensure that all pertinent data have been considered, the audit findings and recommendations will be discussed with the ACO prior to issuance of the report.

c. All audit reports will be submitted to the contract administration office. When significant deficiencies are disclosed, a copy of the report will be forwarded to Headquarters, Attn: O.

d. Contracting officer requests for audits of each C/SSR submission are not expected; however, at those contractor locations where serious deficiencies continue over a period of time, it may be necessary to issue periodic audit reports indicating contractor progress in correcting such deficiencies.

11-306 Contractor Cost Data Reporting (CCDR)

11-306.1 Introduction

The purpose of the CCDR, DD Form 1921, is to collect projected and actual cost data on selected contracts within acquisition programs, from contractors and government facilities, to assist DoD procuring activities in (1) preparing cost estimates for acquisition programs reviewed by the Defense Systems Acquisition Review Council (DSARC); (2) developing independent government cost estimates in support of cost-effectiveness studies, budget/cost comparisons, and contract negotiations; and (3) tracking actual versus contractor negotiated costs.

11-306.2 CCDR Acquisition Program Categories

DoDI 5000.2 has divided CCDR procedures into two acquisition program

categories. Category I applies to all major defense acquisition programs that are designated as Category I acquisition programs by the Under Secretary of Defense, or that are estimated to require an eventual total research, development, test, and evaluation (RDT&E) expenditure of more than \$200 million or an eventual total procurement expenditure of more than \$1 billion in constant fiscal year 1980 dollars. Category II applies to major systems that are designated as acquisition category II programs by the Under Secretary of Defense, or that are estimated to require an eventual total RDT&E expenditure of more than \$75 million or an eventual total procurement expenditure of more than \$300 million in constant fiscal year 1980 dollars. Generally, CCDRs are not required on contracts below \$2 million.

11-306.3 Category I Information Reporting Requirements

a. For Category I acquisition programs, the identification of prime contractors and subcontractors who are required to report is determined during the CCDR plan review process. However, mandatory reporting is required for all aircraft, electronic, missile, ordnance, ship, space, and surface vehicle acquisition programs (and their related components) unless specifically waived by the Chair, OSD Cost Analysis Improvement Group (CAIG). Also, unless waived by the OSD CAIG, reporting is required on firm fixed-price prime contracts or subcontracts when those contracts represent a major share of the research and development or production of a Category I acquisition program or component thereof.

b. Acquisition programs not meeting Category I criteria may be covered by Category I procedures at the discretion of the DoD component concerned or the OSD CAIG.

11-306.4 Category II Information Reporting Requirements

Acquisition programs not covered by Category II procedures may collect cost data using Category II procedures at the discretion of the DoD component concerned. In this regard, reporting of data

will generally not be required on contracts of less than \$2 million or on firm fixed-price contracts.

11-306.5 CCDR Implementing Procedures

To implement CCDR, the procuring activity must prepare a CCDR plan showing the proposed collection of cost data by work breakdown structure for each program being reported, the required CCDR form, and the frequency with which reports are required. The plan normally includes other management system reporting requirements, such as Cost Performance Reports (CPR) and Contract Funds Status Reports (CFSR), to give an overview of all cost data being collected on the contract and the relationships between the reporting systems. The CCDR plan is subject to higher level reviews.

11-306.6 CCDR Information Requirements Forms

a. CCDR forms from the 1921 series are the basis for the contractor's response to the Request for Proposal (RFP). Contractors will submit the Standard Form 1411, supported by the CCDR forms when required by the procuring activity.

b. Cited below are four DD forms for CCDR. Normally all of them will be used for Category I contracts. For Category II reporting, normally only DD Forms 1921-1 and 1921-2 will be used; however, when financing for a Category II contract is substantial enough to require the application of a work breakdown structure, DD Form 1921 may be used at the discretion of the contracting DoD component.

(1) The Cost Data Summary Report (DD Form 1921) summarizes all contract activities and reports total costs against each of the work breakdown structure reporting elements specified in the contract. The contractor submits this report as a program estimate in response to a request for proposal at the time of contract award, and as the contract specifies. It provides summary level cost data cumulatively to date and estimated at completion with a breakout of recurring and nonrecurring costs.

(2) The Functional Cost-Hour Report (DD Form 1921-1) identifies comparable functional cost and labor-hour data; for example, engineering, tooling, and manufacturing for the contract and/or selected reporting elements in the contract. This information is cumulative for both the reporting contractor and subcontract products and services. Category II contract reports also provide current-period functional labor-hour expenditures and data on plantwide labor and indirect costs. A breakout is required for recurring and nonrecurring costs. These reports are also submitted as a program estimate in response to a request for proposal, as a contract estimate 45 days after contract award or signature of a letter contract, and as the contract specifies.

(3) The Progress Curve Report (DD Form 1921-2) provides a unit or an average unit cost of the unit or lot accepted during the reporting period. It also gives functional labor-hour and cost data on the average cost of units or lots accepted, the estimate for the next unit or lot, and the estimate to complete the contract. The contractor must submit the report initially 45 days after contract award or signature of a letter contract and thereafter as specified in the contract. Contracts which do not provide for deliverable end items or hardware do not require this report, nor do requests for proposals.

(4) The Plantwide Data Report (DD Form 1921-3) is a standardized overhead report intended to replace the various types of indirect cost data forms contracting offices previously used for major acquisitions. The contractor prepares the report on the basis of its estimating and accounting systems, although some data may have to be reclassified to ensure a common data base for estimating costs within DoD. The report is required for Category I contracts only and should contain:

(a) Detailed information on major government projects, including the number of units and the procuring activity, and direct cost data by function; for example, engineering and manufacturing. The same data are provided for remaining

plant work segregated between other government and commercial work.

(b) Indirect cost data by function.

(c) Average actual and estimated labor rate data for the four quarters of the current calendar year, as an average for the past year, and as projected for the next two years.

11-306.7 Objectives of the Audit

The auditor is required to evaluate the effectiveness of the contractor's policies, procedures, and practices to produce data compatible with the objectives of CCDR and make selective tests of reported data.

11-306.8 Audit Procedures

a. If the contractor's CCDR system has not been reviewed, evaluate the contractor's proposed procedures for accumulating data and CCDR preparation to assure their compatibility with the accounting system and the reporting requirement in the RFP. Methods for reviewing data in support of a price proposal should not be changed because of CCDR formats; however, the auditor should point out problems caused by system deficiencies to the contracting officer. Identifying and correcting deficiencies is critical at this point because the data, in the prescribed format, become the baseline for negotiation and 10 U.S.C. 2306a and 41 U.S.C. 422 purposes. Forms submitted at the time of contract award become the baseline for DoD data bank purposes and measuring contract performance. Failure to identify and correct major deficiencies would negate the purpose of CCDR by making comparison of data meaningless.

b. Evaluate the effectiveness of the contractor's system, policies, and procedures for accumulating data and preparing CCDRs at least once each year. In this evaluation various CCDRs submitted under each of the contractor's eligible contracts will be selectively tested, to assure that the reported data are accurate and conform to the requirements of DoDI 5000.2. Particular attention should be given to the contractor's estimate at completion. The evaluation should assure that it is the "best estimate" without regard to established ceilings or contract price and that the contractor has properly considered variances between budget and

actual costs in preparing the estimate. Audit reviews will be made more frequently if they disclose significant deficiencies.

c. As with most functional reviews, auditors should consider the results of other evaluations in determining the scope of audit. This will minimize work required to accomplish the objectives of the CCDR review.

d. Compare CCDR data with similar contractor information in other financial management reports such as Contract Fund Status and Cost Performance Reports for agreement or reconcilability.

e. The CCDR review will include evaluating contractor compliance with report due dates in the contracts or established between the contractor and the contracting officer. Discuss deficiencies in meeting due dates with the contracting officer so that corrective action can be taken.

11-306.9 Reporting Results of Audit

a. Prepare a report according to 10-1200 covering the contractor's first CCDR submission which includes actual costs for each contract. The report will state the auditor's opinion on the adequacy of contractor CCDR policies, procedures, and internal controls and the accuracy of reported cost data. Also prepare reports in response to contracting officer's specific requests for audit review.

b. If subsequent reviews of contractor procedures disclose significant deficiencies or the contractor cannot reconcile specific data with similar information for comparable periods, the audit reports will (1) show the deficiencies' effect on the accuracy of the reported cost data, (2) specify reports to which deficiencies pertain, (3) recommend contractor corrective action, and (4) state the contractor's reaction to the recommendations and any corrective action planned or initiated. Audit reports will include the status of any previously reported deficiencies which have not been satisfactorily corrected. To ensure that all pertinent data have been considered, the auditor will discuss findings and recommendations with the contracting officer before the report is issued.

c. All audit reports will be submitted to the administrative contracting officer, with a copy to the designated DoD component official responsible for CCDR, as well as a copy to the Office of the Secretary of Defense Cost Analysis Improvement Group (CAIG) at the following address:

OSD, OD/Program Analysis and Evaluation

Cost Analysis Division
Room 2D278, The Pentagon
Washington, DC 20301-1800

Order Processing Code:

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Mail To: Superintendent of Documents
P.O. Box 371954, Pittsburgh, PA 15250-7954

■ **NOTES ON SUBSTANTIVE CHANGES**

■ **Chapter 1—Introduction to Contract Audit**

■ **Chapter 2—Auditing Standards**

■ **Chapter 3—Audit Planning**

■ **Chapter 4—General Audit Requirements**

■ **Chapter 5—Review of Policies, Procedures, and
Internal Controls Relative to
Accounting and Management Systems**

■ **Chapter 6—Incurred Costs Audit Procedures**

■ **Chapter 7—Selected Areas of Cost**

■ **Chapter 8—Cost Accounting Standards**

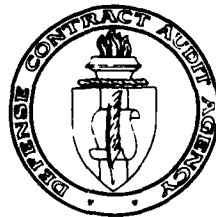
■ **Chapter 9—Review of Cost Estimates and Price
Proposals**

■ **Chapter 10—Preparation and Distribution of Audit
Reports**

■ **Chapter 11—Review of Contractor Compliance
with Contract Financial Management
Requirements**

MARGIN INDEX:

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COMMITMENT TO EXCELLENCE

In support of the National Interest, we are dedicated to providing timely and responsive audits, reports, and financial advisory services to Department of Defense contracting officers and other customers.

Our aim is to be **THE** audit organization with the foremost reputation for competence, integrity, and customer satisfaction by:

- Creating an environment of teamwork, open communication, trust, and mutual respect, and
- Developing highly qualified employees dedicated to the concept of continuous improvement.

William H. Reed
Director

**END
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DATE:

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